



**DISCUSSION DRAFT ON THE ATTRIBUTION OF
PROFITS TO PERMANENT ESTABLISHMENT**

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PREFACE

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital, which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries.

2. There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs. In addition, there is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the need to establish a consensus position regarding the interpretation and practical application of Article 7.

3. As a first step in establishing a consensus position, a working hypothesis (WH) has been developed as to the preferred approach for attributing profits to a PE under Article 7. This approach builds upon developments since the last revision of the Model Commentary on Article 7 in March 1994¹, especially the fundamental review of the arm's length principle, the results of which were reflected in the 1995 OECD Transfer Pricing Guidelines (the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9. The basis for the development of the WH is to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise can be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The ongoing development of the WH will not be constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention is to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade.

4. To meet the policy goals described above, the WH has been tested by considering how it applies in practice to attribute profits both to PEs in general and, in particular, to PEs of businesses operating in the financial sector, where trading through a PE is widespread. This draft contains the results of testing the application of the WH to PEs in general (Part I) and to PEs of banking enterprises (Part II). Testing is still underway for PEs of insurance companies and enterprises undertaking global trading of financial products and is about to begin in the electronic commerce sector for PEs created solely by the existence of a server².

5. The process of testing the WH is not finished and there is not a consensus on how the WH would be applied in practice in certain situations. The WH would also be revised in the light of any particular

¹ This revision followed the publication of "Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments".

² Readers are referred to the discussion draft from the Business Profits TAG on the attribution of profits to a server PE

problems that emerge from the testing process. Nevertheless, sufficient progress on developing an agreed WH has been made for the Committee on Fiscal Affairs to authorise the release of a discussion draft for public comment. It is hoped that the process of public consultation will assist in developing a consensus position regarding the interpretation and practical application of Article 7. The views expressed in the document should not be taken as reflecting the final position of the Member countries of the OECD.

6. Public comments on this document should be submitted in writing to the OECD Secretariat (Jeffrey Owens, Head Fiscal Affairs, 2, rue André Pascal, 75755 Paris Cedex 16, Fax 33 1 4524 1884, E-Mail:jeffrey.owens@oecd.org) by **1st July 2001**. Areas where comments are particularly invited are highlighted in the text. For further information or to discuss the issues raised in the report please contact John Neighbour, Head Transfer Pricing and Financial Transactions Unit, Tel 33 1 4524 9637, E-Mail:john.neighbour@oecd.org.

DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

PART I: GENERAL CONSIDERATIONS

A. Introduction

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the OECD Model Tax Convention in 1963 and its revision in 1977. Currently, the international tax principles for attributing profits to a PE are provided in Article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD Member countries and between many OECD Member and non-member countries. These principles are also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations.

2. The importance of the PE concept can be seen from the following extract from paragraph 1 of the Commentary on Article 7 of the OECD Model Tax Convention:

“When an enterprise of a Contracting State carries on business in the other Contracting State, the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 of the OECD Model Tax Convention on Income and Capital (OECD Model Tax Convention) is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with another enterprise of another Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9 of the OECD Model Tax Convention”.

3. There is considerable variation in the domestic laws of the Member countries regarding the taxation of PEs. Currently, there is also not a consensus amongst the Member countries as to the correct interpretation of Article 7. Indeed, the divergent interpretations as regards the meaning and application of Article 7 in some situations are reflected in the Commentary on the OECD Model Tax Convention

(“Model Commentary”). As pointed out by the business community, the lack of a common interpretation of Article 7 can lead to double taxation. The lack of consensus may also lead to less than single taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the current unsatisfactory situation. The Working Party No. 6 has given the Steering Group on the OECD Transfer Pricing Guidelines (the Steering Group) the initial task of making the situation more satisfactory for taxpayers and for tax administrations.

4. Member countries of the Steering Group agree that the establishment of a consensus position regarding the interpretation and practical application of Article 7 (especially for the purposes of conducting mutual agreement proceedings and interpreting tax treaties based upon the OECD Model Tax Convention) is essential to achieve the goal of eliminating the risk of double, or less than single, taxation. The first step in establishing a consensus position is for the Member countries to develop a working hypothesis (WH) as to the preferred approach for attributing profit to a PE under Article 7 in terms of simplicity, administerability, and sound tax policy. The WH is in the process of being tested by considering its practical application, especially to special issues involving PEs in the financial sector, e.g. banks, global trading and insurance. This report reflects the results of testing the application of the WH to attribute profits to bank PEs. The WH would be revised in the light of any particular problems that emerge from the continuation of the testing process into other areas, such as global trading and insurance.

5. The purpose of this Report is to describe the WH in detail and to provide an explanation of the reasoning behind the adoption of the WH. The process of testing the WH has not yet been completed and there is not yet a consensus on how the WH would be applied in practice in certain situations. The Report reflects the variation in views on certain issues. Nevertheless, sufficient progress on developing an agreed WH has been made for the Committee on Fiscal Affairs to authorise the release of this Report as a discussion draft for public comment. It is hoped that the process of public consultation will assist the completion of the work on developing an agreed way of attributing profits to a PE under Article 7.

6. The discussion in the Report relating to the ongoing development of the WH will not be constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the discussion will focus on formulating the most preferable approach to attributing profit to a PE under Article 7 given modern-day multinational operations and trade. It will be a separate question whether that approach is adequately authorised under the existing language of Article 7 and its Commentary. It may be that clarifying amendments, either to the Article or its Commentary, would be necessary to validate the proposed interpretation. In that case, further work would be needed to consider how best to make the changes, and their possible implications for existing bilateral tax treaty networks. This further work would be carried out in conjunction with Working Party No. 1.

7. The Commentary to Article 7 has itself been regularly updated, including a substantial revision in March 1994 following the publication of “Issues in International Taxation No. 5: Model Tax Convention: Attribution of Income to Permanent Establishments” (hereafter referred to as the 1994 Report). However, the 1994 Report was completed before the CFA had completed its fundamental review of the arm’s length principle, the results of which were reflected in the publication in 1995 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the Guidelines). The Guidelines address the application of the arm’s length principle to transactions between associated enterprises under Article 9 of the OECD Model Tax Convention. The basis for the development of the WH is to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise can be taken. The testing and development of the WH would examine how the guidance in the Guidelines could be applied to attribute profits to a PE in accordance with the arm’s length principle of Article 7. In particular, the extent to which modifications, if any, would be needed in order to take into account differences between a PE and a legally distinct and separate enterprise. It should be noted that under the

WH, the same principles should be applied to attribute losses as to attribute profits. References to attributing “profits” should therefore be taken as applying equally to attributing losses.

8. This Report therefore considers, and where appropriate distinguishes, the guidance given by the Guidelines concerning the application of the arm’s length principle of Article 9. No attempt is made at this stage to resolve all the specific issues that might arise in the PE context, such as the proper treatment of dependent agents, special considerations for financial institutions other than banks, or documentation that would be useful to determining the attribution of profit. Further guidance will be provided on these subjects once the results of testing the application of the WH become available.

9. This Report focuses on determining the preferred application of Article 7. The question of whether the current interpretation of other relevant Articles of the OECD Model Tax Convention (such as Articles 5, 13 and 23) produces a desirable result is beyond the scope of this Report. For example, the Report does not address the question whether a PE exists in respect of any particular business activity. The definition of a PE is described by Article 5 of the OECD Model Tax Convention and readers are referred to its Commentary for further information.

10. The rest of Part I of this Report provides general background and further information about the WH in relation to the first five paragraphs of Article 7. Part B analyses Article 7, paragraph 1, which provides the central rule concerning the allocation of taxing rights over the business profits of an enterprise³ between the country in which the PE is situated (the “host country”) and the country of residence of the enterprise (the “home country”). Part C analyses Article 7, paragraph 2, which provides the central rule concerning the attribution of the business profits of an enterprise to a PE and the statement of the arm’s length principle in the context of PEs. Part D addresses the meaning of Article 7, paragraph 3, regarding expenses, and its relationship to Article 7, paragraph 2. Part E examines Article 7, paragraph 4, which permits in certain circumstances the use of an apportionment method for attributing profits to a PE, based on the total profits of the enterprise. Part F examines Article 7, paragraph 5, which provides a special rule for PEs engaged in the “mere purchase” of goods or merchandise.

11. Part II of this Report examines the special considerations that need to be taken into account when applying the WH to attribute profit to a PE of an enterprise carrying on a banking business. It is expected that the results of testing the application of the WH to PEs of enterprises carrying on global trading of financial instruments and of enterprises carrying on an insurance business will be reflected in Parts III and IV of this Report respectively.

B. Interpretation of paragraph 1 of Article 7: Determining the profits of an enterprise

12. Paragraph 1 of Article 7 permits the host country to tax the “profits of an enterprise”, but only so much of them as is “attributable to” a PE of the enterprise in the host country. Much historical attention has been given to the question of how to determine the attribution under Article 7(2), but in fact another question must first be addressed: what are the “profits of an enterprise” for the purposes of Article 7(1).

13. Unfortunately, the Model Commentary on Article 7 provides little in the way of guidance on how to interpret the term “profits of an enterprise”, beyond confirming that, “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment.” This language limits the scope of the taxing rights of the host country so that there is no “force of attraction” resulting from the existence of a PE (see paragraphs 5-10 of the Commentary on Article 7).

3. For the purposes of this Report, references to the “enterprise” or to the “enterprise as a whole” should be interpreted as describing the juridical entity.

However, the question arises as to whether the term “profits of an enterprise” requires a further limitation on the taxing rights of the host country. Historical practice has developed such that two broad interpretations of the term are most common by the Member countries. Additionally, there are further variations, which may have to be taken into account. The most important of which relates to the meaning of the term “profits”. This part of the Report analyses the two broad interpretations in more detail and discusses briefly possible variations in the interpretation of the term “profits”.

(i) *The “relevant business activity” approach*

14. The first broad interpretation, referred to as the “relevant business activity approach”, defines the “profits of an enterprise” as referring only to the profits of the business activity in which the PE has some participation (the “relevant business activity”).

15. Under the “relevant business activity” approach, Article 7(1) imposes a limit on the profits that could be attributed, under Article 7(2) to a PE: the attributed profits could not exceed the profits that the whole enterprise earns from the relevant business activity. The profits of the whole enterprise would be those earned from transactions with third parties and those earned from controlled transactions with associated enterprises, the latter of which would need to be adjusted under transfer pricing rules if they did not reflect the application of the arm’s length principle.

16. The profits of the enterprise as a whole would be considered as comprising the aggregate of profit and losses derived from all its business activities. Any limitation on the profits attributable to a PE under paragraph 1 of Article 7, would be determined relative only to the profits of the relevant business activity. More specifically, if the “relevant business activity” includes operations by other parts of the enterprise, and those operations incur a loss, the “loss” created by the other parts of the enterprise would effectively reduce the profit that could be attributed to the PE, because the “loss” would reduce the overall profits of the enterprise from the relevant business activity. However, losses from a business activity not considered to be part of the same “relevant business activity” as that carried on by the PE would not reduce the PE’s attributable profit.

17. There are different views among countries as to how the “relevant business activity” approach would be applied in practice. For instance, the breadth or narrowness with which the “relevant business activity” is defined has a significant impact on whether the theoretical profit limitation described above will have any practical effect. There is a greater likelihood that the performance of other parts of the enterprise will limit the attribution of profit to the PE, the more broadly the term “relevant business activity” is defined. For example, consider an enterprise, which manufactures a new type of product at the head office and has a PE, which only carries out a distribution activity. Considerable research expenditure is incurred in developing the product, which results in an overall loss for the product line. The product is not well received in the market and is eventually discontinued. If the “relevant business activity” is considered to encompass all the business activities of the product line, i.e. manufacturing, distributing and research and development, it would not be possible to attribute a profit to the PE for performing only the distribution activity, even if a comparability analysis with uncontrolled transactions undertaken by independent distributors would support such an attribution.

18. On the other hand, if the “relevant business activity” is defined more narrowly by reference to function, rather than product line, there may be less participation by other parts of the enterprise in that function, so that there would be fewer instances in which the profit limitation would be operative. In the example above, it would be possible to attribute profit to the distributor PE based on a functional definition of the relevant business activity, i.e. only by reference to the performance of the distribution function. However, the determination of the “relevant business activity” becomes more difficult where both the PE

and other parts of the enterprise participate in similar activities. Suppose that the enterprise has distributor PEs in two jurisdictions (A and B) and that by following a comparability analysis with uncontrolled transactions undertaken by independent distributors in each jurisdiction, profits could be attributed to A of 10 but B would be attributed a loss of 15, so that the overall distribution business activity for the enterprise as a whole produces a loss of 5. Should Country A limit the definition of “relevant business activity” to the distribution function in its jurisdiction and ignore the distribution function carried on in jurisdiction B? Historically, host countries have proved reluctant to consider limiting their attribution of profit by reference to activities performed by other PEs.

19. The taxing rights of the host country may also be restricted if the “relevant business activity” is interpreted to mean that profits cannot be attributed to the PE unless the activity is carried on only in the jurisdiction of the host country. Such an interpretation may give rise to problems in some cases, for example where the global trading of financial products is carried on in such a way that a number of jurisdictions, rather than just one, would be considered as participating in the “relevant business activity”.

20. There have also been variations between countries in the period over which the “relevant business activity” is evaluated. Some may not evaluate the situation solely by reference to one year. Consequently, if the business activity produced a loss in one year that would not prevent profit being attributed to the PE for that year, if the “relevant business activity” is profitable when looked at over a number of years. A further variation would be for the host country to base its taxing rights on the presumption (always rebuttable by reference to actual experience) that the relevant business activity would make sufficient profits over a period of years so that no restriction to the taxing rights of the host country would arise. In the circumstances described above, some countries would conclude that there are “profits of the enterprise” to attribute, even though they may have been realised at different times in different parts of the enterprise, perhaps because of differences in economic and business cycles. However, the actual attribution of profit would be made separately for each year by reference to the facts and circumstances pertaining in that year. The guidance on using multiple year data in paragraphs 1.49-1.51 of the Guidelines should be applied.

21. Further, some countries apply the limitation under the “relevant business activity” approach by reference to gross profits. Others apply the limitation separately to income and expenses. Some countries apply the profit limitation based on business activity by reference to the combined net profit of the various parts of the enterprise. The first two approaches are likely to produce fewer instances in which the profit limitation would be operative, since the calculation of the limitation would take less account of expenses incurred by other parts of the enterprise.

(ii) *The “functionally separate entity” approach*

22. The second broad interpretation of the phrase “profits of an enterprise” is referred to as the “functionally separate entity” approach. This approach does not limit the profit attributed to the PE by reference to the profit of the enterprise as a whole or a particular business activity in which the PE has participated. Under this approach, paragraph 1 of Article 7 is interpreted as not affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that, “the right to tax [of the host country] does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment”, i.e. there is no “force of attraction” resulting from the existence of a PE (see paragraph 13 above). The profits to be attributed to the PE are the profits that the PE would have earned at arm’s length as if it were a “distinct and separate” enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2). This is discussed in detail in part C below.

23. One key issue in understanding the above approaches relates to the time when profits can be attributed to the PE by the host country. As stated in paragraph 15 of the Model Commentary on Article 7, “Many States consider that there is a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State”. The “functionally separate entity” approach permits profits to be attributed to the PE, even though no profit has yet been realised by the enterprise as a whole, for example when the PE finishes manufacturing semi-finished goods and transfers them to another part of the enterprise for assembly. On the other hand, the “relevant business activity” approach has generally not regarded profits as being attributable to the PE until profits have been realised by the enterprise as a whole from transactions with other enterprises. A transfer of an asset may result in double, or less than single, taxation where the host and home country take different approaches to the question of whether profit can be attributed in respect of that transfer.

24. Another key issue to understanding the above approaches, and which potentially gives rise to double taxation, relates to how the profits to be attributed to the PE are computed. The ways of computing profits may differ because the “functionally separate entity” approach is likely to take as its starting point the dealings of the PE (including those with other parts of the enterprise of which it is a part), whilst the “relevant business activity” approach is likely to take as its starting point the dealings of the enterprise as a whole. In situations where, under the “relevant business activity” approach, there are “profits of the enterprise” to attribute that are at least equal to the quantum of profits computed under the “functionally separate entity” approach, there should, in theory, be no difference to the profits attributed to the PE under either approach. This is because under Article 7(2), the arm’s length principle should be applied in the same rigorous manner to both approaches. However, where the home and host country use different ways of computing profits there may be an increased risk of double, or less than single, taxation in practice, if not in theory.

(iii) *Conclusion*

25. In summary, two broad interpretations of Article 7, paragraph 1, are currently used by Member countries. Despite the fact that the different approaches may produce a similar result in a number of cases, the current lack of consensus is unsatisfactory as it results in a real risk of double, or less than single, taxation, especially in cases where one jurisdiction uses the “functionally separate entity” approach and the other jurisdiction uses the “relevant business activity” approach. Modern business practice and the development of global trading and electronic commerce may make such cases likely to occur with increasing frequency.

26. Of the Member countries that follow the “relevant business activity” approach, most believe that approach is required by Article 7, paragraph 1, given the precise language used in the OECD Model Tax Convention, but that the “functionally separate entity” approach would be preferred if there were more explicit support for it in Article 7 (or its Commentary). These countries believe that the “functionally separate entity” approach would be preferred because it is simpler, more administerable, and more consistent with the understanding of the arm’s length principle as applied in the context of Article 9.

27. From the perspective of simplicity, the “functionally separate entity” approach is preferred because (force of attraction considerations aside), it does not impose any profit limitation on the profits attributable to the PE that might affect the determination of the profits attributable to the PE in accordance with the arm’s length principle under Article 7(2).

28. From the perspective of administrability, the “functionally separate entity” approach is preferred because it does not require the host country to try and determine the enterprise’s world-wide profits from the relevant business activity (except where a profit split method is applied). Furthermore, the “functionally separate entity” approach avoids the need to revisit the assessment when the period of years has elapsed during which it is necessary to consider the performance or non-performance of the “relevant business activity”.

29. The “functionally separate entity” approach may not be more administrable in all cases. The amount of information required under the “relevant business activity” approach may not be too burdensome if a narrow definition of the “relative business activity” is adopted or the approach is applied in the context of an APA under the Mutual Agreement Procedure.

30. From the perspective of consistency, the “functionally separate entity” approach is preferred because it mirrors the type of analysis that would be undertaken if the PE were a legally distinct and separate enterprise. Further, it is more likely to produce a profit attribution in respect of a particular business activity, which is neutral as to whether the activity is carried on by a resident or a non-resident enterprise.

31. Paragraph 4 of this report identified the need to establish a consensus position as to “the preferred approach to attributing profit to a permanent establishment under Article 7”. To achieve this goal it is necessary to choose, for the purpose of testing the WH, one of the two approaches described above. After considering the expected merits of both approaches, the Steering Group has decided, on balance, to adopt the “functionally separate entity” approach as the WH or the preferred interpretation of paragraph 1 of Article 7.

32. Accordingly, the WH is that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2). The phrase “profits of an enterprise” in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that “the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment”(i.e. there should be no “force of attraction principle”).

33. In order to minimise the risk of either double, or less than single, taxation, the WH, once developed, should ideally be applied by countries symmetrically, i.e. in the same manner regardless of whether they are the host or the home country. However, it is recognised that there are currently limitations on the ability of countries to eliminate double taxation in certain situations. The elimination of double taxation depends not just on a common interpretation of the attribution of profit rules of Article 7 but also on the interaction between the domestic laws of the home country for relieving double taxation and Article 23 of the OECD Model Tax Convention. The application of these rules may not lead to symmetrical treatment in all situations, for example when capital assets are transferred from head office to the PE (see section C-2(iv)(a)1). Remedying this situation would require changes to countries domestic law on double taxation relief, and possibly changes to Article 23, and so is beyond the scope of this Report. However, the development under the WH of a common interpretation of Article 7 should reduce the incidence of double taxation by reducing one common cause of double taxation, i.e. differences in the way countries compute the quantum of profit to be attributed to a PE in respect of dealings between one part of an enterprise and another part of the same enterprise. It is also possible that countries will consider changes to their domestic laws that take into account the approach of the WH, once there is an international consensus on the interpretation of Article 7.

34. It should be noted that the WH does not dictate the specifics or mechanics of domestic law, but only sets a cap on the amount of attributable profit that may be taxed in the jurisdiction of the PE. In order to comply with the strictures of Article 7(2), it is not necessary for the domestic law of the host jurisdiction to expressly incorporate the arm's length standard – although, of course, this is the course taken by some countries' laws. Rather, the domestic law of a host jurisdiction may be phrased in different terms, and adopt different mechanical rules, so long as it is recognised that if these domestic rules result in an excessive attribution of profit, as compared to what may be justified under the arm's length principle of Article 7(2), then the Article 7(2) limit prevails.

35. It is noted for information that the Member countries of the Steering Group have also considered two other possible interpretations of the phrase “profits of an enterprise”, even though these other interpretations have not been used in practice. The first interpretation is that the phrase “profits of the enterprise” refers to the total net profits of the enterprise as a whole. Under this approach, the PE could not have a profit attributed to it in excess of the total *net* profits of the enterprise of which it is a part. Such an interpretation has no regard to the possibility that the total net profits may have been reduced due to losses from activities completely unrelated to the activities of the PE.

36. The second interpretation would define “profits of the enterprise” as the enterprise's total gross profit. Under this approach, the PE could not have a profit attributed to it in excess of the total *gross* profits of the enterprise of which it is a part. Such an approach suffers from the same problem identified in the preceding paragraph, although to a lesser extent because the limitation is applied at the level of gross, and not net, profit. In short, both approaches were rejected as not being supported by the language of Article 7, and not achieving a result consistent with sound tax policy.

37. Another issue that arises, concerns how countries define the term “profits”. There is no definition of this term in Article 7 (see paragraph 32 of the Model Commentary) and so the host country may apply the relevant definition found in its domestic law. For the purposes of eliminating double taxation under Article 23 of the OECD Model Tax Convention, the home country would compute profits according to the definition found in its domestic law. This may well differ from the amount of profits attributed by the host country (see paragraphs 39-41 and 62 of the Model Commentary on Article 23). It is not appropriate to address this issue in this Report as it is of wider significance and is not confined to PEs.

C. Interpretation of paragraph 2 of Article 7: Determining the profits attributable to the Permanent Establishment

38. Paragraph 2 of Article 7 provides that, “subject to the provisions of paragraph 3” of Article 7, the profits to be attributed to a PE are:

“the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.”

39. This approach has its origins in the “independent enterprise” and “separate accounting” approach adopted by the League of Nations in 1932/33 and can be considered the statement of the arm's length principle in the context of PEs. Paragraph 11 of the Commentary on Article 7 indicates that this language “corresponds to the “arm's length principle” discussed in the Commentary on Article 9.” The Guidelines issued in 1995, contain a detailed analysis of how to apply the arm's length principle under Article 9 in the context of an MNE group. This guidance is more recent than the latest changes made to the Model Commentary concerning the application of the arm's length principle under Article 7.

40. Accordingly, the Member countries of the Steering Group are of the opinion that the working hypothesis should be based on the premise that the guidance on the application of the arm's length principle of Article 9 given by the Guidelines should be applied to the attribution of profit to a PE using the arm's length principle under Article 7(2). The Steering Group is in the process of testing the working hypothesis in a number of factual situations and business sectors to examine whether this premise should be adopted as the standard for attributing profit under Article 7(2).

41. However, apart from the issues already discussed in Part B in relation to paragraph 1 of Article 7, there are two further issue areas that warrant attention under Article 7 as distinguished from Article 9.

- (1) For the purposes of Article 7, it is necessary to postulate the PE as a hypothetical enterprise that is distinct and separate from the enterprise of which it is a PE, whereas in an Article 9 case the enterprises being examined are actually legally distinct and separate; and
- (2) One of the two common interpretations of paragraph 3 of Article 7 would modify the arm's length principle as regards the quantum of expenses to be allowed as deductions when attributing profit to a PE, as discussed in Part D below.

42. To reflect the above issues, the working hypothesis is to apply the guidance given in the Guidelines not directly but by analogy. This Report discusses how and to what extent the guidance in the Guidelines can be applied, by analogy, to attribute profits to a PE and how to adapt and supplement that guidance to take into account factual differences between a PE and a legally distinct and separate enterprise.

43. The preferred interpretation of Article 7(2) under the working hypothesis is that a two-step analysis is required. First, a functional and factual analysis in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks. Second, an analysis of the Guidelines relevant to applying the arm's length principle to the hypothesised enterprises so undertaking functions, using assets, and assuming risks. These two steps are discussed, respectively, in Sections C-1 and C-2 below.

C-1 First step: Determining the activities and conditions of the hypothesised distinct and separate enterprise

44. The first step of the working hypothesis is based on the following part of Article 7(2), which states that the PE must be hypothesised as a distinct and separate enterprise "engaged in the same or similar activities under the same or similar conditions". The approach of the Guidelines in linking the earning of profit to the performance of "functions" would appear to be capable of being applied in the PE context by equating "functions" to "activities".

45. Further, the guidance on comparability at paragraph 1.15 of the Guidelines equates "conditions" with "economically relevant characteristics". There is also an obvious similarity between the concept of "same or similar" and the concept of "comparability" discussed in Chapter I of the Guidelines. As noted by paragraph 1.17, "it is necessary to compare attributes of the *transactions or enterprises* (emphasis added) that would affect conditions in arm's length dealings." In the PE context, some of the "conditions" of the PE as a hypothesised distinct and separate enterprise will be derived from a functional and factual analysis of the internal attributes of the enterprise itself ("internal conditions"), whilst other "conditions" will be derived from a functional and factual analysis of the external environment in which the functions of the PE are performed ("external conditions"). Unless stated otherwise in the text, the term "conditions" refers to both "internal" and "external" conditions.

46. In short, the first step of the working hypothesis will apply a functional and factual analysis to the PE (based on the guidance in Chapter 1 of the Guidelines) in order to determine the functions of the hypothesised distinct and separate enterprise and the economically relevant characteristics (both “internal” and “external” conditions) relating to the performance of those functions.

(i) *Functions (activities).*

47. The guidance in the Guidelines on functional analysis seems capable of being applied fairly directly in the PE context in order to determine the “activities” of the hypothesised distinct and separate enterprise. The main difficulties are with determining how to take into account assets used and risks assumed. These are discussed later in this section. However, the guidance on comparability cannot be applied directly in the PE context and needs to be applied by analogy. This is because the guidance in the Guidelines is based on a comparison of the conditions of controlled and uncontrolled transactions. However, what is needed in the first step of the working hypothesis is a factual analysis of all the economically relevant characteristics (“conditions”) relating to the PE so as to ensure that the “distinct and separate” enterprise is appropriately hypothesised to be engaged in “comparable” activities under “comparable” conditions to the PE.

48. The guidance on comparability in Chapter I of the Guidelines describes some factors in addition to a functional analysis (characteristics of property or services, contractual terms, economic circumstances and business strategies) which may have to be taken into account when undertaking a comparison of conditions. By analogy, such factors should also be considered when undertaking the factual analysis to determine the “conditions” of the hypothesised distinct and separate enterprise and to ensure that they are “same or similar” to those of the PE. So under the working hypothesis, care needs to be taken to ensure that the attribution of profit takes into account the conditions of the enterprise to the extent those conditions are relevant to the performance of the PE’s functions.

49. In the distributor example at paragraph 18 above, a full functional and factual analysis of the distribution function would be undertaken under the first step of the working hypothesis. This would determine the economically relevant characteristics relevant to the performance of the distribution function by the PE, for example, the identification of a business strategy such as a market penetration scheme. It would be important to identify any business strategy in order to undertake properly the comparability analysis under the second step of the working hypothesis between the dealings between the PE and the rest of the enterprise of which it is part and transactions between independent enterprises. Such a “condition” might explain why in the example at paragraph 18 above, it may be appropriate to attribute a loss to B but not to A, for example because the enterprise as a new entrant to the market in B has been carrying out a market penetration scheme.

50. Chapter I of the Guidelines provides a considerable amount of detail about functional analysis and its application. The Guidelines at 1.20 state that a functional analysis “seeks to identify and compare the economically significant activities and responsibilities undertaken or to be undertaken by the independent and associated enterprises.” In the PE context, the functional analysis will be initially applied to the hypothesised distinct and separate enterprise and the rest of the enterprise of which it is a part in order to determine what economically significant activities and responsibilities are undertaken by the PE and how they relate to the activities and responsibilities of the enterprise as a whole. The functional analysis must also determine which of the identified activities and responsibilities of the enterprise are associated with the PE, and to what extent. Where the PE is created through a fixed place of business within the meaning of Article 5(1), the determination of which activities and responsibilities of the enterprise are associated with the PE should be determined from an analysis of the “fixed place” that constitutes the PE and the functions performed at that “fixed place”. Where there is a PE by virtue of

Article 5(5) of the OECD Model Tax Convention (an “agency PE”), the functional analysis would have to take into account any functions undertaken by the agent on behalf of the enterprise.

51. In many cases, all the activities necessary to carry on the business through a fixed place take place within the PE’s jurisdiction. For example, the PE may act as a distributor and carry on all the associated activities, including market research, in its jurisdiction. However, it is important that the functional analysis includes not just activities taking place in the jurisdiction of the PE, but all activities performed on behalf of the PE and all activities performed by the PE on behalf of other parts of the enterprise. In another case, a functional analysis may show that some activities necessary to carry out the distribution function, say market research, are performed in a different jurisdiction. Such activities will have to be taken into account when attributing profit to the PE, although the exact manner of doing so will depend on an analysis of the facts and circumstances.

52. The functional analysis needs to be carried out in a thorough and detailed manner in order to establish the exact nature of the function being performed. For example, in the banking area a detailed functional analysis may show that the activities of a branch consists not only of borrowing and on-lending of money to the usual customers of the branch but may include “agency or conduit transactions” as described in the 1984 OECD Report, “Transfer Pricing and Multinational Enterprises - Three Taxation Issues; -The Taxation of Multinational Banking Enterprises (1984 Report)”. Following the approach of the Guidelines, these two different activities would be treated as two different functions for the purposes of determining the profits to be attributed to the PE. This issue is discussed in detail in Part II of this Report.

(ii) *Assets used*

53. Again following, by analogy, the guidance in the Guidelines, the functional analysis must also take into account the assets used and risks assumed by the PE including, where there is an “agency” PE, any assets used and risks assumed through the agent. Determining the assets used and risks assumed of a PE can be particularly difficult, because these items belong, legally, to the enterprise of which the PE is part. However, in determining the characteristics of the PE for taxation purposes, it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity.

54. Legal ownership of the assets rests with the enterprise as a whole. However, as a part of the first step of the analysis under Article 7(2), it must be determined how the assets of the enterprise should be taken into account when postulating the hypothetical “distinct and separate enterprise”. The question is to determine whether the PE is making use of the assets of the enterprise in its business, and, if so, on what basis. Guidance on this issue can be found in the approach adopted in the Guidelines. This approach can be readily adapted to the hypothetical enterprise construction required by Article 7(2) because it recommends a functional analysis that takes into account “assets *used* ”(emphasis added), with no reference to legal ownership.

55. Following this approach by analogy, the members of the Steering Group are of the view that in applying Article 7(2), the facts and circumstances must be examined in order to determine the extent to which the assets of the enterprise are used in the functions performed by the PE. To the extent that assets are used in the functions performed by the PE, the use of those assets should be taken into account in attributing profit to the functions performed by the PE. Assets of the enterprise that are not used by the PE should not be taken into account for the purposes of attributing profits to the PE. Although a tax examiner will normally start with the branch accounts, it may be that some assets used by the PE have not been recorded in those accounts, but should be taken into account for the purposes of attributing profits. For this, and other reasons (e.g. because of the lack of legally binding contractual relationships between different

parts of the same enterprise), it is particularly important for a taxpayer to document the methodology used to attribute profits to a PE.

(iii) *Risks assumed*

56. As regards risk, in the context of a PE and its head office, as contrasted with a parent company and its subsidiary, it is the enterprise as a whole, which legally bears the risk. However, following the analysis of assets, the members of the Steering Group likewise conclude that it is possible to treat the PE as assuming risk, even though legally the enterprise as a whole assumes the risk. Indeed, the PE should be considered as assuming any risks inherent in, or created by, the PE's own functions (i.e. for the purpose of the PE), and any risks that relate directly to those activities. For example, the PE should be treated as assuming the risks arising from negligence of employees engaged in the function performed by the PE. The determination of the risks assumed by the PE has consequences for determining the allocation of capital and the capital adequacy of the PE. This is because an enterprise assuming material additional risks would need to correspondingly increase its capital in order to maintain the same credit rating. The capital issue is discussed in general in section C-2 (iv)(d). This issue is extremely significant for banks and is discussed in detail in Part II.

57. In the absence of contractual terms between the PE and the rest of the enterprise of which it is a part, determining what assumption of risks should be attributed to the PE will have to be highly fact specific. Following, by analogy, paragraph 1.28 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be, "deduced from their [the parties] conduct and the economic principles that govern relationships between independent enterprises." This deduction may be aided by examining internal practices of the enterprise (e.g. compensation arrangements), by making a comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risk has been made.

58. In summary, to the extent that risks are found to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should be taken into account when attributing profit to the performance of that function by the PE. If risks are found not to have been assumed by the enterprise as a result of a function performed by the PE, the assumption of those risks should not be taken into account for the purposes of attributing profits to the PE. It should be noted that this discussion of risk only relates to the assumption of risks, inherent in, or created by, the performance of a function. It will be a separate question (to be dealt with in Section C-2 below) how to take into account any subsequent dealings related to the subsequent transfer of risks (e.g. when a loan is transferred from a PE to another part of the enterprise) or to the transfer of the management of those risks to different parts of the enterprise.

(iv) *Conclusion*

59. More work needs to be done on this issue. In particular, the working hypothesis that the risks assumed by a PE are determined by reference to the functions it undertakes, will certainly need to be tested in a variety of practical situations. Testing the working hypothesis will expose the extent to which it may be necessary to adapt the guidance of the Guidelines to the PE context. Some members of the Steering Group see a tension between the need to hypothesise on the one hand, the PE as a distinct and separate enterprise dealing wholly independently with the rest of the enterprise and, on other hand, the mitigating factors on the PE's actual risks assumed that may result from its belonging to a wider enterprise, which constitute an "internal" condition of the enterprise that must be taken into account. In the view of such

countries this tension affects the determination of the risks that the PE should be considered to assume under the WH.

60. Preliminary views seem to be that a functional analysis is capable of determining which activities should have profits attributed to them, including what assets are used and what risks are assumed and the “external” conditions under which those functions are performed. The determination of the “internal” conditions under which the PE performs those functions currently, is less straightforward, except in situations where the “internal” condition is related directly to an external activity. The guidance in Chapter 1 of the Guidelines on comparability analysis may assist in determining the conditions of the PE. For example, if the factual and functional analysis shows the PE as a new entrant in a market, the hypothetical distinct and separate enterprise postulated under the first step of the WH would be treated as operating under the same conditions as independent enterprises that were also new entrants in that market.

61. Some countries believe the determination of the “internal” conditions of a PE (like the determination of the “external” conditions) simply follows from a functional and factual analysis. Others remain to be convinced that a functional and factual analysis is sufficient to make this determination and that it is still necessary to hypothesise which of the “internal” conditions of the enterprise should be treated as “internal” conditions of the PE and which should not be so treated. Further, they believe the WH needs to address this limitation to the “functionally separate entity” approach and provide practical guidance as to how to determine the “internal” conditions of the PE and the effect that such “internal” conditions have on the attribution of profit to a PE.

62. These issues are still under active consideration by the Steering Group and are discussed in detail in Part I of this report in a general context (see especially the sections on intangibles (section C-2 (iv)b) and on capital structure (section C-2(iv)d) and in Part II of this report in the context of a banking business (see especially the section on credit rating and capital structure (section D-1(ii) and (iii)). It is hoped that the testing process will assist in providing a principled and consistent way of determining the conditions of a PE that can be applied consistently across various business areas and in relation to a number of issues. The results of testing the application of the WH in the banking sector, including the determination of the internal and external conditions of the hypothesised distinct and separate enterprises, are described in Part II of this Report.

C-2. Second step: Determining the profits of the hypothesised distinct and separate enterprise based upon a comparability analysis

(i) Introduction

63. In general, Member countries agree that the working hypothesis should provide for the choice and application of methods described in the Guidelines to be applicable when determining the profits to be attributed to a PE based upon its functions performed (taking into account assets used and risks assumed in the manner described in the foregoing section). The PE should obtain an arm’s length return for its functions, taking into account the assets used and risks assumed, in the same manner as would a comparable independent enterprise.

64. A functional and factual analysis of the PE will already have been accomplished in the process of constructing the hypothetical “distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions”, in the manner described in the preceding section. However, the language of Article 7(2) goes on to require that the profits to be attributed to the PE must also be based on the hypothetical distinct and separate enterprise, “dealing wholly independently with the enterprise of which it is a permanent establishment”. In some cases, it may therefore be necessary to carry out a

functional analysis of another part of the enterprise (of which the PE is a part) if the other part contributes to the functions being performed by the PE or undertakes activities in relation to the assets being used or the risks assumed by the PE, or vice versa.

65. Continuing to follow, by analogy, the approach of the Guidelines, profits should be attributed to a PE by applying the traditional transaction methods (CUP, resale price and cost plus), or, where such methods cannot be applied reliably, the transactional profit methods (profit split and TNMM).

66. The question arises as to how to adapt the guidance of the Guidelines on transfer pricing methods to the PE context. In an Article 9 situation, there are “controlled transactions” between associated enterprises, and the transfer pricing methods apply by comparing those transactions with comparable uncontrolled transactions between independent enterprises. In the PE situation there are “dealings” rather than actual “controlled transactions” that govern the economic and financial relationships between the PE and another part of the enterprise.

67. The working hypothesis is to undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the PE context means either that there are no differences materially affecting the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences. Principles similar to the aggregation rules of Chapter I of the Guidelines should also apply, to permit the PE’s dealings to be aggregated, where appropriate, in determining the PE’s attributable profit. The rest of this section looks at some of the issues identified above in a little more detail.

(ii) *Recognition of dealings*

68. An important threshold question is whether inter-branch dealings have taken place and so should be recognised for the purposes of attributing profit. In the associated enterprise situation it will usually be self-evident that a transaction has occurred, e.g. the transaction will have legal consequences other than for tax. However, a dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is often inferred solely for the purposes of determining an arm’s length attribution of profit. Consequently, it will be necessary first of all to determine whether any dealing exists before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm’s length attribution of profit.

69. The starting point for the evaluation of a potential “dealing” will normally be the accounting records of the PE showing the purported existence of such a “dealing”. Under the working hypothesis, that “dealing” will be recognised for the purposes of attributing profit, where it relates to a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc). A functional analysis should be used to determine whether such an event has occurred and should be taken into account as an inter-branch dealing of economic significance.

70. This will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the “dealing”. In transactions between independent enterprises, the determination of the transfer of risks, responsibilities and benefits would normally require an analysis of the contractual terms of the transaction. This analysis would follow the guidance on contractual terms found in paragraphs 1.28 and 1.29 of the Guidelines.

71. A dealing takes place within a single legal entity and so there are no “contractual terms” to analyse. However, the WH treats “dealings” as analogous to transactions between associated enterprises and so the guidance in paragraphs 1.28 and 1.29 can be applied in the PE context by analogy. In particular, as noted in paragraph 1.28, “The terms of a transaction may also be found in correspondence/communications between parties other than a written contract.” So, by analogy, the “contractual terms” are the accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part. Further, where no accounting records or internal documentation exists evidencing a dealing which has been found to have occurred, the “terms of the dealing”, by analogy with paragraph 1.28, must be deduced from the conduct of the PE and the other parts of the enterprise and the economic principles that generally govern relationships between independent enterprises. All the facts and circumstances surrounding the dealing will have to be examined in order to deduce the economic relationships between the parties.

72. Functional analysis can be used to show the actual conduct of the parties and so can be used to check whether the documented terms, if any, of the economic relationship were followed in practice. Such an examination is considered necessary even where there are contractual terms between legally distinct, albeit, associated enterprises. Paragraph 1.29 of the Guidelines states that it will be necessary to, “examine whether the conduct of the parties conforms to the terms of the *dealing* or whether the parties’ conduct indicates that the *terms of the dealing* have not been followed or are a sham.” The paragraph goes on to note that in such cases, “ further analysis is required to determine the true terms of the transaction.” Such an analysis will be even more important in the PE context where any terms between the various parts of the enterprise are not contractually binding.

73. In summary, an accounting record showing a “dealing” that transfers economically significant risks, responsibilities and benefits would therefore be taken into account for the purposes of attributing profits, unless the analysis of the conduct of the parties fails to show that the transfer of economically significant risks, responsibilities and benefits has actually taken place.

74. Once the above threshold has been passed and a dealing recognised as existing, the WH applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and the other parts of the enterprise. So the examination of a dealing, should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III. Except in the two circumstances outlined at paragraph 1.37, tax administrations should apply the guidance in paragraph 1.36 when attributing profit to a PE and so “ should not disregard the actual *dealings* or substitute other *dealings* for them.”

75. In the banking area, some countries have expressed concern that applying the guidance described above to inter-branch dealings involving the recognition of internal hedges and transfers of financial assets may weaken the existing defences against tax motivated transfers (see paragraph 15.2 of the Model Commentary on Article 7). Guidance is needed on the circumstances in which it would be appropriate to recognise an internal hedge and the transfer of a financial asset under the working hypothesis. The WH is to base such recognition only where there has been a transfer of economically significant functions and of the associated risk and profit potential. Such issues are discussed in further detail in Part II of this Report. The issue of whether it would be appropriate to recognise internal re-insurance arrangements will be one of the main issues to be examined when testing the application of the WH to an enterprise carrying on an insurance business through a PE.

(iii) *Applying transfer pricing methods to attribute profit*

76. Consider a PE that distributes a product manufactured by its head office. The PE's dealings that are at issue are the obtaining of the product from the head office, and the sale of the product to a third party customer. The third party sales price is by definition at arm's length and so the transfer pricing examination would be focused on the dealings with head office. To determine the PE's attributable profit from these dealings, the transfer pricing methods would be applied in light of the PE's business activities and functions as a distributor. If, for example, the head office also sells the product to third party distributors, the CUP method might be used to determine the profit that the PE would have obtained had it been a "distinct and separate enterprise" within the meaning of paragraph 2 of Article 7. The amount of gross profit attributed to the PE would be determined as the difference between revenues received by the PE from third party customer sales and the price charged by the head office, adjusted, if necessary, to the arm's length price by reference to comparable transactions between third party distributors and manufacturers.

77. Where a CUP is unavailable, the PE's gross profit might be determined based upon a comparable resale price margin percentage applied to the third party customer sales revenues. Net profit would then be computed by deducting expenses incurred by the enterprise for the purposes of the PE, including appropriate reflection of compensation for any functions performed by other parts of the enterprise for the purposes of the PE. See Part D, below. This result is consistent with paragraph 17.3 of the Model Commentary on paragraph 3 of Article 7, which states:

"Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles."

The same approach would be used in applying the other methods described in the Guidelines. This approach determines the profit of the PE in the host country. It should be noted that the timing of profit recognition for the purposes of relieving double taxation in the home country will depend on the interaction between Article 23 and domestic law and may be different.

78. An issue arises where there is a dealing between the PE and another part of the same enterprise and there are costs related to that dealing that have been incurred by the other part of that enterprise. To the extent that the costs that have been incurred by the other part of the enterprise have been reflected in the arm's length price for that dealing, these costs should not be allocated to the PE. Moreover, care is needed with regard to the internal accounting for the costs attributed to different dealings, e.g., to ensure that costs covered in a dealing are not also claimed again under another dealing. For example, product testing costs relating to an arm's length CUP for a product "sold" to the PE may not also be claimed a second time as part of "services" charged to the PE under a cost-plus method. The issue is akin to the issue addressed by paragraph 7.26 of the Guidelines and the guidance in that paragraph will be relevant by analogy for the situation where there is a dealing between the PE and another part of the same enterprise.

79. When attributing profit to the PE, it may also be necessary to take into account expenses incurred by the enterprise for the purposes of the PE, where such expenses represent functions (performed by other parts of the enterprise) for which compensation would be charged at arm's length. Subject to the preceding paragraph, the method by which this is achieved may vary. Some countries prefer to take such compensation for functions performed by other parts of the enterprise into account, by adjusting the gross profit margin to reflect the performance of those functions. The actual amount of expenses incurred by other parts of the enterprise in performing those functions should not be deducted to arrive at the PE's arm's length net profit. Other countries prefer a two step analysis. First, the gross margin for the PE based

on comparables would be determined, without taking into account compensation for the functions performed by other parts of the enterprise. Second, an appropriate compensation for the functions performed by other parts of the enterprise would be determined based on comparables and this amount would be deducted to arrive at the PE's arm's length net profit. Both methods should produce the same result.

80. The transfer pricing methods are intended to determine the arm's length compensation for the functions that the PE performs, taking into account assets used and risks assumed. As discussed in Section C-1(i) above, the functional analysis undertaken to construct the hypothesised distinct and separate enterprise would have already determined the characteristics and functions of the PE, including a determination of the assets used and risks assumed.

81. The risks assumed by the enterprise as a whole, which are not directly attributable to activities carried on by particular parts of the enterprise, may still need to be taken into account in some manner when attributing profit to the PE using the arm's length principle. Such risks might enter into the analysis of whether the conditions of the dealings between the PE and the enterprise of which it is a part are comparable with conditions of the transactions between independent enterprises.

82. Where the PE has dealings with other parts of the enterprise, those dealings (provided they pass the threshold test above) will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the PE and the other parts of the enterprise, taking into account assets used and risks assumed. For example, the PE may begin to use assets (tangible or intangible) belonging to the enterprise that were developed by the head office or purchased for the business of the head office or vice versa. The PE may use services rendered by the head office or vice versa. The PE may use cash earned by the head office or vice versa. Under the WH, inter-branch dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods (either by sale, licence or lease) between independent enterprises. However, the working hypothesis is based on the premise that the inter-branch dealings are postulated solely for the purposes of attributing the appropriate amount of profit to the PE.

(iv) *Comparability analysis*

83. The Guidelines identify 5 factors determining comparability between controlled and uncontrolled transactions; characteristics of property or services, functional analysis, contractual terms, economic circumstances and business strategies. The WH seeks to apply the same factors to ensure comparability between dealings and uncontrolled transactions. It is considered that all the factors, with the exception of contractual terms, can be applied directly to evaluate dealings as they are essentially based on fact. The concept of contractual terms is rooted in relationships between legally distinct, albeit associated, enterprises and so needs to be applied by analogy to dealings within a single legal entity (see discussion at paragraphs 68-73 as to how to apply, by analogy, the guidance on contractual terms at paragraphs 1.28 and 1.29 of the Guidelines). Once the "contractual terms" of the internal dealings have been determined, a comparison can be made with the contractual terms of potentially comparable transactions between independent enterprises.

84. The comparability analysis might determine that there has been a provision of goods, services or assets etc. between one part of the enterprise and another, that is comparable to a provision of goods, services or assets etc. between independent enterprises. Accordingly, the part of the enterprise making such a "provision" should receive the return which an independent enterprise would have received for making a comparable "provision" in a transaction at arm's length. In an arm's length transaction an independent enterprise normally would seek to charge for making a provision in such a way as to generate profit, rather

than providing it merely at cost. Although there can be circumstances in which a provision made at an arm's length price will not result in a profit (e.g. see paragraph 7.33 of the Guidelines in connection with the provision of services).

85. Another outcome of the comparability analysis might be that the PE and the other part of the enterprise dealing with the PE would be found to be acting, under all the facts and circumstances, in a comparable manner to economic co-participants in an activity corresponding theoretically to a cost contribution arrangement (CCA). If the PE and the rest of the enterprise are found to be economic co-participants in such an activity, the dealings would be treated in a manner similar to transactions between associated enterprises in a CCA.

86. Further guidance will be needed in order to determine how the guidance in Chapter VIII on determining whether a CCA between associated enterprises satisfies the arm's length principle can be applied, by analogy, in the PE context. Contemporaneous documentation of the "CCA" activity and the intentions of the participants will be helpful in determining the true nature of the economic relationships between different parts of the enterprise.

87. For example, where a PE is claimed to be a participant in a "CCA" type activity within a single enterprise, there should be sufficient evidence available to enable the tax authority in the PE's jurisdiction to evaluate whether the PE's contribution to the "CCA" type activity is, as stated at paragraph 8.8 of the Guidelines, "consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to receive from the arrangement." Documentary evidence will be helpful in making this evaluation, provided it reflects the real situation and any documented intentions are put into effect and followed during the life of the "CCA" activity.

88. The comparability analysis may also result in other outcomes than those described in the previous paragraphs. Member countries are of the opinion that these other outcomes should be equally susceptible to analysis, by analogy, with the guidance contained in the Guidelines.

89. The current approach found in the Model Commentary is based on the nature of the property involved, for example by presuming that the supply of goods for resale creates a provision, whilst a supply of intangible property would not. This approach also creates problems where different types of property are supplied as part of a package. One analytical tool currently used by Member countries to determine the effect of inter-branch dealings on the attribution of profit is the "direct or indirect approach" outlined in paragraph 17.2 of the Model Commentary. This approach is based on the premise that provisions should be postulated, and arm's length prices charged, in cases where the relevant functions contribute directly to the realisation of profit from external entities. However, this view requires a determination of which functions contribute directly, as opposed to indirectly, to the earning of profit. It is also considered that it may be extremely difficult to find objective criteria for making the determinations described earlier in this paragraph. Accordingly, Member countries of the Steering Group agree that the working hypothesis is to reject the current approach based largely on the nature of the property or services involved and use of the "direct and indirect approach" in favour of applying the comparability approach, by analogy, based on the guidance in the Guidelines.

90. To summarise, where inter-branch dealings take place, the factual and comparability analysis will attribute profit in respect of the dealings by reference to comparable transactions between independent enterprises. The guidance in the Guidelines on undertaking such analyses will be applied, by analogy, in light of the particular factual circumstances of a PE and as a result of testing the working hypothesis. Four particular circumstances are considered in this regard: use of capital assets, use of intangible assets, provision of internal services, capital allocation and funding of the PE's operations.

(a) Capital assets

91. As discussed above, assets of the enterprise are attributed to a particular PE based upon use. Accordingly, where a PE has used a capital asset from the time of its acquisition by the enterprise, there would be normally no inter-branch dealing with respect to that asset to take into account in the attribution of profit. There is the possibility of another part of the enterprise receiving some reward if it undertook an economically significant function related to the acquisition. In the latter case, a comparison would have to be made with independent enterprises performing the same function in comparable circumstances, in order to see whether any profit would need to be attributed for performing the related function. However, where no other part of the enterprise has been involved in any way with the acquisition or use of the machine, for example where a PE manufactures property using a machine owned by the enterprise but always used by the PE, the PE would be attributed profit arising from the use of the machine, just as if the PE were a separate entity owning and using the machine. Other expenses (e.g. depreciation) related to the use of the machine would also be attributed to the PE.

92. In contrast, significant issues may arise where there is some change of use of a capital asset. The Steering Group has been examining two particular situations: (i) change in use of a capital asset; and (ii) temporary use of a capital asset.

1. Change in Use of a Capital Asset

93. The situation may arise in which the use of a capital asset by one part of an enterprise, e.g. the head office is changed to use by another part of the enterprise, e.g. the PE. In accordance with the principles of paragraphs 53-55 and 68-73 above, change of use does not simply mean change of the location of the asset: there must be an intention that the asset will be used by the PE for a dealing to be recognised. For instance, if both the head office and the PE engage in a manufacturing function, and the head office no longer has need for a particular machine, that machine might be moved from the head office to the PE for use in the manufacturing business of the PE. After this removal, the functional analysis of Article 7(2) would show the PE as using the asset, and accordingly the profits associated with the use of the asset would become attributable to the PE. The removal of the machine from the head office to the PE is a real and identifiable event, and so would constitute an inter-branch dealing.

94. The question then becomes how to account for the acquisition and use by the PE of an asset, when computing the amount of profit that should be attributed to the PE. Should the PE be treated as having “bought” the capital asset from the head office? Should the PE be treated as leasing or renting the capital asset? Is it possible for the PE to be treated as a participant in a “CCA” type activity in respect of the capital asset?

95. However, answering these questions raises some issues owing to the special factual circumstances of a PE. If there had been a change of use of a capital asset between two independent enterprises, the question as to whether the asset had been bought, leased or rented would have been determined by examining the contractual arrangements between the parties (provided their actual conduct followed the contractual arrangements, see paragraphs 1.28-1.29 of the Guidelines). However, legally binding contractual arrangements do not exist where the change of use of the capital asset has occurred within the same enterprise. Instead, the determination must be made by making a full examination of the facts and circumstances surrounding the change in use, including the subsequent conduct of the parties and any relevant documentation.

96. The intent of the enterprise in effecting this change of use, as documented and as corroborated by its conduct, will be relevant in determining the nature of the dealing. The following is a non exhaustive list of factors which may be taken into account in determining the intent of the enterprise: whether the PE

existed at the time the asset was first acquired, whether there has been a change in the activity of the PE, the use to which the enterprise puts the asset or similar assets in the course of its business, its importance to the business of the PE, whether there was a reasonable expectation that the PE would benefit from using the asset at the time it was acquired and the division of the risks of ownership between the parts of the enterprise, e.g. the responsibility for repairing the asset if it is damaged, etc.

97. Once the full facts and circumstances have been established, the nature of the inter-branch dealing (sale, lease or licence) would be determined by reference to the nature of comparable transactions between independent parties. For example, a short term transfer to the PE and, therefore, the fact that the asset is intended for subsequent use by another part of the enterprise, may be indicative that the head office bears most of the risks, which may be consistent with a short term rental arrangement. On the other hand, if the PE is responsible for the regular maintenance of an asset for which maintenance is a significant cost or has to recruit personnel to perform unforeseen repairs, it may be that the PE is assuming most of the risks associated with the use of the asset, a situation more consistent with a sale. In this context, it may be relevant to establish whether the enterprise itself owns the assets, leases it or rents it from an independent supplier and to know what independent parties would do in similar circumstances. As noted in paragraph 71 above, while the documentation of the arrangement will assist in the determination, if the conduct of the parties is inconsistent with this documentation, consideration must be given to the actual conduct of the PE and the rest of the enterprise in order to establish the true nature of the arrangement.

98. The determination of the nature of the dealing would be assisted by reference to the terms agreed between the parties (whether explicit or implicit), following, by analogy, the guidance given by paragraphs 1.28 and 1.29 of the Guidelines (see general discussion at paragraphs 68-73 above).

99. If it is considered that the factual situation reflects the provision of a capital asset in a manner comparable to an outright sale between independent enterprises, the fair market value of the asset at the time of transfer would need to be established. Under the WH, where the asset is transferred from head office to the PE, the fair market value would provide the basis upon which an allowance for depreciation would be computed in the host country. The computation of the depreciation allowance would be made according to the domestic law of the host country for each year in which the asset is used by the PE.

100. Again, where the asset is transferred from the PE to another part of the enterprise, the fair market value of the asset at the time of transfer would generally be used as the basis upon which an allowance for depreciation would be computed in the country to which the asset had been transferred (but with regard to transfers to the head office see paragraphs 103-105). The situation in the PE country will depend on its domestic law and the interaction between domestic law and Article 7.

101. The domestic law of many countries will recognise for tax purposes the transfer of the asset from their jurisdiction, for example by computing a profit or loss by comparing the fair market value of the asset at the time of transfer with its book value or its depreciated cost base for tax purposes (see paragraph 15 of the Model Commentary on Article 7). However, the domestic law of some countries will not permit the unrealised profit from such a transfer to be taxed, although a loss may have to be allowed under the provisions of an applicable tax treaty. It should also be noted that the WH only determines the attribution of profits to a PE under Article 7. The WH does not override domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets.

102. Differences in domestic law treatment between home and host country may give rise to double taxation due to an asymmetric treatment of the transfer of the asset. For example, if the asset is transferred to head office in a jurisdiction, which would not recognise the unrealised profit from the notional transfer, the taxpayer will not get immediate relief for any tax paid in respect of that transfer in the jurisdiction of the PE.

103. For the WH to apply in a completely symmetrical manner, the jurisdiction of the head office would need to recognise that the transfer into its jurisdiction gives rise to a disposition of the asset by the enterprise and an immediate reacquisition at fair market value. This would produce a profit or gain that could be taxed in the head office jurisdiction, thereby permitting that jurisdiction to provide relief against that profit or gain for the tax paid in the jurisdiction of the PE in respect of the transfer. However, the absence of a right to tax the profit or gain under the domestic law of the head office jurisdiction would mean that it is not possible to tax the profit or gain on the transfer and so provide for immediate double taxation relief.

104. The above situation is one where the working hypothesis could not be applied in a symmetrical manner without a change in the domestic law of the head office. As discussed at paragraph 33 above, remedying such a situation is beyond the scope of this Report. However, if the asset is ultimately disposed of by the enterprise at a profit or gain, partial or complete relief from double taxation may be achieved at that time, if the head office jurisdiction is a credit country and allows for the carryover of unused credits from the time of the transfer of the asset from the PE.

105. If it is considered that the factual situation reflects the provision of a capital asset in a manner comparable to a lease or a licence between independent enterprises, no profit or loss at the time of the transfer of the capital asset would have to be recognised. Instead, profits would be attributed between the parties to the notional transfer, based, for example, on a comparable transaction between independent enterprises (a lease or a licence). Therefore, when computing its taxable profits, the PE would be entitled to deduct an amount equivalent to the arm's length charge for the use of the lease or licence that would have been agreed upon between independent enterprises had they entered into the same transaction. Whether the dealing representing the change of use of the asset was comparable to a lease as opposed to a licence would be determined under the approaches already described in paragraphs 93-95 above.

106. Another possibility might be that the PE and other parts of the enterprise would be found to be acting, under all the facts and circumstances, in a comparable manner to economic co-participants in a "CCA" type activity that contemplates serial use of a capital asset by different parts of the enterprise. Following, by analogy, the guidance given in Chapter VIII of the Guidelines there might not be a need in such cases to recognise any appreciation (or depreciation) at the time of the change in the use of the capital asset, if the asset were transferred between "participants" in a manner consistent with the contemplated serial use of the asset under the "CCA" type activity.

107. In other cases, there may still be a need to recognise any appreciation or depreciation in the value of a capital asset following a change of use, even where a "CCA" type activity has been found to exist. For example, the asset may no longer be used in the activity which is the subject of the "CCA" or because one part of the enterprise involved in the change of use has ceased to be a participant in the "CCA" type activity or because another part of the enterprise has started to use the asset and has become a new participant in the "CCA" type activity.

2. Temporary Use of a Capital Asset

108. Under the working hypothesis, there would be no need to distinguish between a temporary and a more permanent change of use of an asset. The approaches described at paragraphs 95-99 above would be applied to determine what profit, if any, should be attributed to the PE in respect of the temporary change of use of the capital asset. All of the various outcomes described in the previous sub-section could occur.

(b) Intangible property

109. Similar to the situation described above for capital assets, intangible assets will also be attributed to a particular PE based upon use. Accordingly, where one PE has used intangible property from the time of its acquisition by the enterprise, there would be normally no inter-branch dealing with respect to that asset to take into account in the attribution of profit. However, there is the possibility of another part of the enterprise receiving some reward if it undertook an economically significant function related to acquisition of the intangible property.

110. However, more commonly, intangible property owned by the enterprise will have arisen as a result of R&D activities (common for trade intangibles) or marketing and advertising activities (common for marketing intangibles) undertaken by the enterprise itself. Further, and unlike the situation involving capital assets (considerations relating to CCAs aside), it is common for intangible property to be used simultaneously by more than one part of the enterprise. Significant and even more complex issues may arise where there is some change of use in relation to intangible property.

111. The general presumption in the 1994 Report was that notional payments are not recognised for the use of intangible property by one part of the enterprise, i.e. notional royalties, are not allowed. The position reached in the 1994 Report is reflected in the comments at paragraph 17.4 of the Model Commentary, which advise that:

“Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprises without any mark-up for profit or royalty.”

112. However, it is overly prescriptive to allow only one approach for dealing with the variety of ways in which intangible property can be exploited. Indeed, although the language of paragraph 17.4 of the Model Commentary (reproduced above) favours the cost allocation model, there is a clear implication that arm’s length notional payments between different parts of the enterprise could be allowed if the costs of creation could actually be identified as having been, in practice, incurred by one part of the enterprise. Unfortunately, the paragraph does not explicitly distinguish between legal and economic ownership (see paragraph 53 above) and this may have led to an overstatement of the difficulty in identifying which part of the enterprise has borne the costs and risks of creating and developing the intangible property. Nor has it recognised that more than one part of the enterprise may have contributed to the development of the intangible property. Once again the guidance in the Guidelines may help here. In particular, the concept of functional analysis would be applied in order to determine which, if any, part of the enterprise could be identified as having performed the function of creating the intangible.

113. Under the working hypothesis, the decision about attribution of profits based upon an inter-branch dealing in relation to intangible property would be fully dependent on an analysis of the facts and circumstances. The exact nature of the dealing would be determined by reference to the nature of comparable transactions between independent enterprises. As with capital assets, there are a number of possibilities. The intangible property or, more likely, an interest in the intangible property could be considered to have been “bought”. A “licence” to use that intangible property could have been obtained etc. There could be a joint development of the intangible property in a manner comparable to a “CCA”

type activity between independent parties. In making this determination, documentary evidence as to the intention of the parties together with an analysis of their conduct is likely to be helpful (see paragraphs 95-99 or further discussion of this issue in relation to a change of use of a capital asset).

114. The following is a non-exclusive list of factors that may be taken into account when determining whether the function of creating the intangible property has been undertaken at least in part, by the PE: The PE directs the research and development; the PE was in existence and in the business of exploiting (through manufacture, distribution or otherwise) intangible property of a similar nature at the time the intangible property at issue was developed or would have an expectation of being able to exploit the property in its business when developed; the researcher has no capacity of its own to exploit the intangible property and does not license such property to third parties; the PE's business would be seriously affected if the R&D were to fail to produce intangible property; the PE has documented the importance of the intangible property to its business purpose by recording the R&D expense on its branch accounts or other internal management accounts.

115. If it is determined under the functional analysis that the PE has performed, at least in part, the function of creating the intangible or bears extraordinary marketing expenditure in relation to the intangible, the PE would be entitled to a comparable return to that of an independent enterprise performing a similar function. The guidance in Chapter VI on special considerations for intangible property should be followed, by analogy, when making the attribution of profit to the PE performing that function, or the guidance in Chapter VII, in respect of any services provided in connection with the development of the intangible property. The conditions under which the PE performs that function also need to be taken into account. If the conditions were comparable to those of a contract researcher within the meaning of paragraph 7.41 of the Guidelines, the researcher PE would be attributed a profit consistent with that earned by independent enterprises performing a similar function as contract researchers. Another possibility might be that both the PE and other parts of the enterprise have jointly contributed to the development of the intangible property, for their joint purposes, in which case profit would be attributed between the contributing parties, based on what would happen between independent parties participating in a comparable "CCA" type activity. The guidance given in Chapter VIII of the Guidelines would be followed, by analogy.

116. Just as in the case of capital assets, even more difficult questions can arise when an enterprise exploiting an intangible property, say, in head office, provides to one or more of its PEs the notional right to use the intangible property. For example, a PE may begin to make use of an intangible developed in the past by activities in the head office, and exploited in the past by the head office. This situation commonly arises because of business changes, for example, the PE moving into a new business area. Under the WH, a functional and comparability analysis of the situation might show that the PE should be treated as engaging in a dealing with the head office, in respect of that intangible property. Profit would be attributed in respect of this dealing by reference to comparable transactions between independent enterprises (e.g. royalty payments) and would depend on a factual and functional analysis of the dealing, the type of interest obtained or notional rights acquired (exclusive or non-exclusive) etc. Guidance on these issues is given in Chapters VI and VIII of the Guidelines.

117. As stated above, unlike the situation involving capital assets, it is common for intangible property to be used simultaneously by more than one part of the enterprise. Making an intangible asset available to a PE does not imply that other parts of the enterprise have ceased to be able to exploit that same asset or may not be able to do so in the future. Such a change in use could result in the PE being treated as having obtained not the intangible asset itself or an exclusive notional right to use the intangible, but rather a beneficial interest in that asset or a non-exclusive right to use the intangible. Thus, under the working hypothesis the PE would be treated as having acquired an interest in the intangible or a notional right to use the intangible at the time of the change of function.

118. The value of the interest acquired (outright ownership or a beneficial interest) would be determined by reference to comparable transactions between independent enterprises. The PE might be treated as having acquired the intangible or an interest in the intangible at fair market value and so be entitled to depreciate/amortise the interest in the acquired asset using that value. This would put the position of intangibles (where the facts and circumstances suggest that the treatment discussed in this paragraph should apply) on a par with that of tangible assets transferred for the use of the PE and not for resale.

119. Another possible outcome of the analysis of the dealing involved in making an intangible available to a PE could result in the PE being treated as having obtained a notional right to use the intangible property analogous to a licensing agreement. Depending on the factual circumstances and the comparability analysis, the PE might be entitled to deduct an amount equivalent to the arm's length charge (notional royalty) for a license arrangement that would have been agreed upon between independent enterprises had they entered into the same transaction.

120. It should be noted that the analysis in paragraph 118 deals only with the direct consequences of the transfer of the intangible asset itself or a beneficial interest in an existing intangible asset. In circumstances where the intangible is to be further developed by the enterprise as a whole, it might be that such further development would be conducted in a "CCA" type activity to which the PE is a participant. Although, the PE would be treated for tax purposes as if it had acquired an interest in the existing intangible property (a buy in), any subsequent dealings related to the further development of the intangible property would be determined by following, by analogy, the guidance given in Chapter VIII of the Guidelines. If, by following, by analogy, the guidance of Chapter VIII, the PE were found to have acquired only the notional right to use the existing intangible that is subject to the "CCA" type activity and did not obtain a beneficial interest in the intangible property itself, a notional royalty may be attributed based, by analogy, on the guidance in Chapter VI.

121. The application of the WH to use of intangible property within an enterprise is in the process of being tested. One difficulty that needs to be explored further is how to ensure that the analysis applied in this section for intangibles is consistent with the analysis applied to other "internal" conditions of the PE as a hypothesised distinct and separate enterprise. This issue has already been flagged at paragraph 61. Another difficulty that needs to be explored further is to examine the efficacy of concepts such as exclusive and non-exclusive notional rights to use intangible property and the acquisition of an interest (outright ownership or beneficial ownership) in the context of a single legal entity. **Comments on these issues from the public would be particularly welcome.**

(c) Internal services

122. The Model Commentary at paragraph 17.7, presumes that services which are related to the general management activity of the enterprise should normally be allocated at cost. The provision of a mark up (or more strictly an arm's length price) is restricted to certain cases (see the comments at paragraph 17.5 and 17.6), for example where it is the trade of the enterprise to provide such services to third parties or where the main activity of the PE is the provision of services to the enterprise as a whole and where those services are both a significant part of the expenses of, and provide a real advantage to, the enterprise.

123. In respect of this view, it is informative to recall that the Guidelines have updated the principles cited in the Model Commentary on Article 7 concerning the situations in which associated enterprises should be permitted to transfer property or services to each other without realising a profit. The Model Commentary on Article 7 uses an interpretation of the arm's length principle that pre-dates the Guidelines.

Under the former interpretation, specific factual circumstances were established in which associated enterprises might deviate from the arm's length principle and transact with each other at cost⁴. The factual circumstances related to whether the transaction involved goods/services offered regularly to third parties: the "direct or indirect approach". The Guidelines have revised this interpretation, so that associated enterprises are always required to comply with the arm's length principle. But it is specifically recognised that there are times when the arm's length principle would result in a transaction taking place without the realisation of a profit. See paragraph 7.33 of the Guidelines.

124. The WH is to attribute profit to a PE in respect of services performed by the PE for other parts of the enterprise (and vice versa) by following, by analogy, the guidance given in the Guidelines, especially Chapter VII. In some cases, the PE and the other parts of the enterprise can be considered as acting in a comparable manner to economic co-participants in a "CCA" type activity involving the provision of those services. The inter-branch dealings within the enterprise would be treated for tax purposes in a like manner as a provision of comparable services between independent parties in a comparable "CCA" type activity, following, by analogy, the guidance given in Chapter VIII of the Guidelines.

125. Testing the application of the WH to the provision of services within a banking enterprise has identified two main issues that require further examination. First, some concern has been expressed that the WH would mean that where the PE could have obtained comparable services more cheaply from independent enterprises than from the head office, not all of the expenses incurred by the head office on behalf of the PE in providing those services could be passed on to the PE. A similar issue occurs between associated enterprises and is discussed at paragraph 7.34 of the Guidelines. The WH is to apply that guidance, by analogy, in the PE situation.

126. Second, a question has been raised as to whether any of the oversight functions of head office should be treated as analogous to activities that would be undertaken in the capacity of a shareholder in the MNE group context, as distinct from activities analogous to those of a service provider (see paragraphs 7.9-7.10 of the Guidelines). The implication of this approach is that the expenses incurred by head office related to "shareholder" activities would not be passed on to the PE. The guidance at paragraph 7.6 may be useful in resolving this issue. That paragraph states that, "If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm's length principle." Applying this guidance by analogy, an activity performed by one part of the enterprise would not be recognised as a "service" for another part of the enterprise unless that part of the enterprise would have been willing to pay for, or perform, that activity itself. These issues are explored in Part II of this Report for a PE of a banking enterprise.

127. Some Steering Group members have expressed reservations about the desirability and practicability of the outcome described above. **Views from the public are invited on this issue.**

(d) Capital allocation and funding the operations of the PE

Introduction

128. Enterprises require capital in order to fund day to day business activities, the cost of creating or acquiring assets (tangible, intangible and financial), and to assume the risks associated with an ongoing business (e.g. credit and market risk). Broadly, capital comes from three sources: (1) contributions of

4. See paragraphs 81-83 of the 1984 OECD Report, "Transfer Pricing and Multinational Enterprises - Three Taxation Issues; The Allocation of Central Management and Service Costs".

equity by shareholders; (2) retained profits (referred to collectively in this report as equity or "free" capital); and (3) borrowings (i.e. debt capital). Under tax law, deductions are generally not given for payments made to equity holders, whereas deductions are generally available (subject to thin capitalisation rules etc) for payments of interest or interest equivalents to the holders of debt capital.

129. Because interest expense is generally deductible for tax purposes, it will be necessary to ensure an appropriate allocation of the enterprise's "free" capital to a PE in order to ensure an arm's length attribution of profits to the PE. Unfortunately, the achievement of this desirable goal is made difficult by the current lack of consensus on a number of key issues related to the capital allocation and funding of a PE. This section analyses the current interpretation of Article 7 in respect of these key issues before going on to describe how the WH would apply to allocate capital and funding costs to a PE. Some possible variations in the approach of the WH to particular issues are also discussed.

Current interpretation of Article 7

130. There are a number of key issues identified in the Model Commentary on Article 7 that require resolution under the WH. One key issue in allocating capital and funding costs to a PE, relates to the treatment of internal movement of funds. The conclusion at paragraph 18.3 of the Model Commentary is that the "ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below." Paragraph 19 goes on to recognise that "special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises." However, currently there is not a general consensus as to what special considerations should apply to financial enterprises. Some Member countries directly take into account internal interest payments at arm's length prices. Others will only apportion a fraction of the actual interest paid by the enterprise as a whole.

131. Another key issue is how to take the capital of the whole enterprise into account when attributing profit. Paragraph 20 of the 1994 report considers that some internal interest adjustment should be allowed where there is a bilateral agreement that the PE is either over or under capitalised and indicates that:

"The answer to the question as to whether a permanent establishment is under- or over-capitalised will, in principle, depend on the rules and practice of the host country, unless there is a divergent mutual agreement under Article 25 of the Model Tax Convention".

132. However, a mutual agreement may be difficult to achieve because of the different approaches member countries currently take to attributing the capital of the enterprise as a whole to its constituent parts. At one end of the spectrum is a type of "single entity" approach, that regards the PE as having a similar capital structure and debt/equity ratio to that of the enterprise as a whole. At the opposite end of the spectrum, is a type of "separate enterprise" approach which largely ignores the capital structure of the enterprise as a whole and regards the PE as having a similar capital structure to that of an independent enterprise in that jurisdiction carrying on the same or similar activities under the same or similar conditions (a type of thin capitalisation approach).

133. These issues needs further exploration and are under active consideration by the Steering Group during the process of testing the WH. Additional background material may be found in the discussion on interest in the 1984 Report, the 1987 OECD Publication: Thin Capitalisation and for a more recent summary - Section IV- 4 of the 1998 OECD publication The Taxation of Global Trading of Financial Instruments: A Discussion Draft.

The WH for attributing capital and funding costs to a PE

134. The Steering Group has made good progress in determining how capital allocation and funding issues should be dealt with for banks. This is discussed in detail in Part II of this report. However, the Steering Group is still discussing the issues for non-banks. One issue is how to treat financial institutions that are not regulated as banks (non-bank financial institutions) for the purposes of the WH. The proposal is that the same principles that apply to the attribution of capital to a bank PE should apply to non-bank financial institutions. Otherwise, there will be a considerable opportunity for tax arbitrage, e.g. financial institutions regulated as banks may get a different treatment from financial institutions carrying on similar activities that are not regulated as banks.

135. For the purposes of this Report, a non-bank financial institution will include the following:

- Enterprises which, although not registered as banks, are subject to financial regulation in a manner similar to banks, such that regard might be had to their risk weighted assets and the capital necessary to support them;
- Enterprises which risk weight their financial assets in the ordinary course of business; and
- Enterprises, whether or not subject to regulation, where the business of the enterprise consists wholly or mainly of performing financial services for (e.g. borrowing from and lending of money to) unconnected parties on arm's length terms.

This definition may be revised depending on the results of testing the application of the WH to PEs of enterprises carrying on other types of financial activities, e.g. insurance companies and enterprises conducting global trading of financial instruments. It should be noted that this definition would only apply for the purposes of applying the WH. It would not apply for other tax purposes.

136. The rest of this section discusses how to apply the WH to PEs in the context of capital allocation and funding issues. Four main issues arise and are discussed below. The first is how to determine the capital structure and debt/equity ratio of the PE, especially how to allocate "free" capital to a PE. The second is whether a movement of funds within an enterprise could be treated as a dealing giving rise to interest. The third is how to determine the amount of interest expense that should be attributable to a PE and how to make any necessary adjustments to the interest expense recorded in the books of the PE. The fourth, is how to determine what credit rating should be attributed to a PE.

1. The WH for allocating "free" capital to a PE

137. Tax considerations aside, and in the absence of regulatory requirements, there is ordinarily no need for any equity or "free" capital to be formally endowed to a PE. Consequently, the PE's funding needs could be entirely debt funded. Nevertheless, while the PE may not need to have equity or "free" capital allocated to it, the enterprise as a whole will need to ensure that it has adequate equity or "free" capital to support any third party borrowings, including any undertaken through the PE. Moreover, if the same operations were carried on through a subsidiary in the host jurisdiction, the subsidiary would need to have some equity or "free" capital to support its third party borrowings.

138. Under the WH, the PE needs for tax purposes to have attributed to it an arm's length amount of "free" capital, irrespective of whether any such capital is actually allocated to the PE. To do otherwise is unacceptable on tax policy grounds - the result is not neutral between residents and non-residents (it favours non-residents), does not follow the arm's length principle and, in jurisdictions with thin

capitalisation rules, produces a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations. The latter provides considerable scope for tax avoidance.

139. A potential solution to the above problem is discussed in this section, which considers how to attribute the “free” capital of an enterprise to a PE under the WH. At first sight, the functional basis of the WH would appear to favour the adoption of the “separate enterprise” approach described at paragraph 132 above. However, it is also necessary under the first step of the WH to analyse not only the functions of the hypothesised distinct and separate enterprise but also the “conditions” under which those functions are performed (see paragraphs 45 and 46). That way the “distinct and separate” enterprise can be appropriately hypothesised as engaging in comparable activities under comparable conditions to the PE. As shown by the preliminary results of testing the application of the WH to a bank PE, many countries view the capital structure of the PE as an “internal” condition of the enterprise as a whole. One result of this conclusion would be that the amount of “free” capital that could be attributed to a PE would not be able to exceed the amount of “free” capital of the enterprise as a whole.

140. The preliminary results of testing the application of the WH to a banking PE viewed the credit rating and capital structure of the PE as two of the economically relevant characteristics (“internal” conditions) of the enterprise as a whole. Accordingly, under the WH, the “distinct and separate enterprise” hypothesis would require that an appropriate portion of the entity's “free” capital would need to be attributed to its branches for tax purposes. It is worth re-emphasising that an attribution of “free” capital may have to be made for tax purposes, even though there may be no need to formally allocate “free” capital to the PE for any other purpose.

141. The next issue is how to attribute the “free” capital of the enterprise as a whole to the various parts of the enterprise. The attribution would be made in accordance with where the assets are used and the associated risks assumed and should take into account, as far as practicable, the specific functions, assets and risks of the PE relative to the functions, assets and risks of the enterprise as a whole. This recognises that some business activities involve greater risks and require more capital than other activities, hence the business activities undertaken through a PE may require proportionately more or less capital than the enterprise as a whole.

142. The starting point for attributing the “free” capital of an enterprise to its PEs is to attribute the assets of the entity. The next step is to determine the amount of “free” capital needed to support those assets. The WH is to make this determination in accordance with the arm’s length principle. Part II of this report considers in detail the issues relevant for banks. This sub-section considers how the WH applies these steps for enterprises that are not banks, including non-bank financial institutions (see paragraph 135 above).

Step 1 - Attributing and risk weighting assets

143. Under the WH, assets would be attributed to a PE based on where the assets are used and where the risks associated with those assets are assumed. This approach is similar in principle to that used for banks (see Part II) and raises the issue of whether, as for banks, an attempt should be made to risk weight the assets. For banks it is possible to use an internationally accepted method (developed by the Basel Committee on Banking Supervision) to risk weight their assets, whilst there is no such internationally accepted method available to risk weight assets of non-banks.

144. However, the importance of risk for the providers of financial assets (i.e. non-bank financial institutions), means that such institutions are likely to try and risk weight their assets. This may be done for business reasons and/or to meet regulatory requirements. The risk weighting of assets is consistent with the arm’s length principle, as independent enterprises would need to allocate more capital to riskier assets.

Accordingly, the WH is to use risk-weighted assets for non-bank financial institutions as the first step in attributing capital to a PE of such an institution. There are a variety of ways this risk weighting could be done, depending on the type of non-bank financial institution. For some, it may be possible to follow, or adapt, the regulatory approach to risk weighting assets for that type of institution. Other institutions may risk weight their assets for business purposes, even if not required to do so by regulators or if they are unregulated. For others, it may be possible to adapt the regulatory approach used for banks.

145. Enterprises that are not banks or non-bank financial institutions (“non-financial institutions”) are less likely to risk weight their assets for business purposes on a day to day basis and will not be subject to regulatory requirements requiring them to do so. Where non-financial institutions do not risk weight their assets, it is suggested that capital should be attributed by reference to where the assets are used and by reference to the relative value of the assets used by different parts of the enterprise. It will therefore be important to value the assets in a consistent manner across different parts of the enterprise. There are a number of possible valuation options. One option would be to use the book value of the asset as shown in the accounts for the relevant period. Another option would be to use the market value of assets, either as a matter of course or in cases where there is a significant difference between book and market value. Another option would be to use the original purchase price or cost of the asset. Whatever valuation options are used, the aim should be to ensure that the PE has a sufficiently adequate capital base and debt/equity ratio to support the activities it undertakes and so approximate to an arm’s length result. **The Steering Group would particularly welcome public comment on the valuation issues and the possibilities for risk weighting assets of non-financial institutions.**

Step 2 – Determining the capital needed to support the assets attributed to the PE

146. Having attributed the applicable assets of the enterprise to the PE based on use (and where necessary risk weighting or adjusting the book value of those assets as discussed above), the next step in order to apply the arm’s length principle is to determine how much of the enterprise’s “free” capital is needed to cover those assets and to support the risks assumed.

147. The starting point is to ascertain the amount of “free” capital of the enterprise as a whole. As stated in paragraph 128, equity or “free” capital in broad terms comprises contributions of equity by shareholders and undistributed profits. Reserves are also often included in “free” capital, although practice amongst Member countries may vary. In general, for the purpose of the WH, the debt/equity characterisation rules used for tax purposes in the PE’s jurisdiction would be applied to the enterprise’s capital for the purpose of determining which items would be treated as “free” capital for tax purposes under the domestic laws of the host jurisdiction.

148. It is noted that debt/equity characterisation rules for financial instruments may vary from country to country and that such variation may result in double, or less than single, taxation. While less variation in such rules between jurisdictions may be desirable, it is not appropriate to address this issue in the WH. This issue is of wider significance and is not confined to PEs. It is also noted that such an issue is more likely to be of concern for banks and for the activities of non-bank financial institutions related to the borrowing and lending of money for which the regulatory approach discussed in Part II has been suggested.

149. There seems to be a consensus that a PE should have sufficient interest “free” capital to support the functions it undertakes, the assets it uses and including the risks it assumes. However, there is not yet a consensus on how to make this attribution of interest “free” capital.

150. One approach favoured by many Steering Group members is to attribute the “free” capital of the enterprise as a whole to the various parts of the enterprise. The attribution would be made in accordance

with where the assets are used and the associated risks assumed. So if under the first step described above, 10% of the assets and risks of the enterprise were attributed to a PE, then 10% of the interest “free” capital of the whole enterprise would also be attributed to the PE. The consequences of such an attribution on the interest expense claimed by the PE are discussed later in this section at paragraphs 162-164.

151. However, some Steering Group members consider the above approach departs from the premise of the WH which is based on a functionally separate entity approach. They consider that some type of thin capitalisation approach would be theoretically more appropriate, even though there are likely to be some practical problems in applying such an approach. In particular, under a thin capitalisation approach it may be possible to attribute either more, or less, than the capital of the enterprise as a whole. However, those countries already apply such approaches and have not found the practical problems insurmountable.

152. There are two main ways of applying a type of thin capitalisation approach to attribute capital to a PE. The first is by reference to the minimum dotation (interest free) capital that a PE is required to have under their domestic law or a minimum level found in broadly similar enterprises in the jurisdiction of the PE (a quasi thin capitalisation approach). The second is by reference to the capital structure and debt/equity ratio of an independent enterprise carrying on the same or similar activities, using the same or similar assets and assuming the same or similar risks under the same or similar conditions (a thin capitalisation approach).

153. Problems can arise in cases in which the “free” capital of the enterprise as a whole has been kept artificially low (e.g. where a guarantee has been provided to the enterprise, or for tax avoidance purposes) as applying the hypothesised “distinct and separate enterprise” approach of the WH would not give an arm’s length result. Various remedies are available, including applying some type of thin capitalisation approach in such cases.

154. In conclusion, there is an emerging consensus that a single internationally accepted method for attributing the actual capital of the enterprise would be desirable in order to minimise the incidence of double taxation and it is hoped that the process of public consultation will assist in its development.

2. The WH for the recognition of internal interest dealings

155. A further issue relates to the determination of whether an internal transfer of funds should be recognised as a “real and identifiable event”, i.e. a “dealing” that could give rise to “interest”. The current approach of the Model Commentary described at paragraph 130 above, makes a distinction between financial and non-financial enterprises based on the fact that the making and receiving of advances is closely related to their ordinary business (the “direct or indirect approach”). The WH rejects such an approach in favour of applying the comparability approach of the Guidelines (see paragraph 89 above). In principle, this would depend on a functional and factual analysis of the “dealing” and the conditions under which it was performed.

156. For “non-bank financial institutions”, the functional and factual analysis of such activities is likely to produce similar results as for a bank (see Part II of this Report) and so a recognition of internal “interest” in relation to those activities could be appropriate for the attribution of an arm’s length profit to a PE. Accordingly, it would not be necessary to separately attribute the actual interest expense of the enterprise, although it would still be necessary to attribute the actual “free” capital (see above).

157. For “non-financial institutions”, a comparability analysis under the second step of the WH may well recognise some internal movements of funds as “dealings” comparable to transactions between independent enterprises giving rise to interest. In other situations, for example where the movement of funds are related to the buying and selling of goods or services on normal credit terms, the “dealings”

would not be treated as giving rise to interest under the comparability analysis. For PEs of non-financial institutions, there are likely to be many such small movement of funds in relation to the provision of goods and services within the enterprises. For administrative simplicity, it is therefore proposed to make an exception to the strict application of the WH in such cases. Accordingly, the WH would not recognise internal “interest” for non-financial institutions but instead an appropriate amount of the actual interest expense of the enterprise should be attributed amongst the various parts of that enterprise.

158. The next issue is how to attribute the interest expense for non-financial institutions to the various parts of the enterprise. It should be noted that, only the arm’s length interest expense of the enterprise as a whole would be attributed. This may require the application of transfer pricing rules under Article 9 of an applicable tax treaty or under domestic law in the absence of such a treaty, if any of the interest expense of the enterprise relates to transactions with associated enterprises.

159. Two approaches for attributing the actual interest expense of the enterprise to its PEs are often mentioned: (1) a tracing approach, and (2) a fungibility approach. A number of countries currently use some variation of these approaches. Under a “pure” tracing approach, any internal movements of funds provided to a PE are traced back to the original provision of funds by third parties. The interest rate on the funds provided to the PE are determined to be the same as the actual rate incurred by the enterprise to the third party provider of funds. Under a “pure” fungibility approach, money borrowed by a PE of an enterprise is regarded as contributing to the whole enterprise’s funding needs, and not simply to that particular PE’s funding needs. This approach ignores the actual movements of funds within the enterprise and any payments of inter branch or head office/branch interest. Each PE is allocated a portion of the whole enterprise’s actual interest expense paid to third parties on some pre-determined basis.

160. Both a tracing approach and a fungibility approach, at least in their pure form, have problems. The Model Commentary on Article 7 also remains equivocal on this issue. Paragraph 18.2 states:

“The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality.”

One situation where adjustments are made by some countries to reflect economic reality is in relation to non-recourse debt. The view being taken that the risk to the enterprise in the event of default is limited to the particular asset that has been financed.

161. No firm conclusions have yet been drawn, beyond agreeing not to impute “interest” on internal movement of funds in a non-financial institution. Some countries favour a fungibility approach, whilst others want to retain tracing of funds for non-financial institutions. Others want a more flexible approach, perhaps by using tracing for “big-ticket” items and a fungibility approach for the rest of the assets. These issues need further exploration and are under active consideration by the Steering Group. **Comments on these issues from the public would be particularly welcome.**

3. The WH for adjusting the interest expense claimed by a PE

162. Finally, once the arm’s length amount of “free” capital attributed to a PE has been determined, a comparison needs to be made with the actual “free” capital, if any, allotted to the PE by the enterprise.

Where the amount of “free” capital allotted by the enterprise is less than the arm’s length amount as determined above, an appropriate adjustment would need to be made to reduce the amount of interest expense claimed by the PE in order to reflect the amount of the enterprise’s “free” capital that is actually needed to support the activities of the PE.

163. Where interest bearing debt attributed to the PE (including recognised “interest” dealings in respect of internal movements of funds) covers some part of the arm's length amount of "free" capital properly attributable to the PE, any interest on the amount so covered would not be deductible in arriving at the PE's taxable profits. In some cases, the PE's accounts may specifically identify the interest liability in relation to the amount of "free" capital that has been covered by interest bearing debt. In these cases, it may be a fairly simple matter to determine the amount of non-deductible interest. In other cases, the PE's accounts may not readily identify any specific interest liability in relation to the amount of "free" capital that has been covered by interest bearing debt. This raises the question of how to determine the amount of non-deductible interest.

164. One method for determining the amount of non-deductible interest might simply be to apportion the actual interest expense claimed by the PE (after any adjustment to reflect arm's length amounts) by using a ratio based on the average debt level that the PE had during the year, and the average debt level that the PE would have had during the year after adjustment to reflect the additional "free" capital that should have been attributed to the PE. Another method might be to use a weighted average of rates actually charged on the interest bearing debt attributed to the PE. It is also desirable to allow the use of other methods where the results produced are more acceptable to the taxpayer and to the tax administration of the host jurisdiction.

4. The WH for determining the credit rating of a PE

165. Section D-1 (ii) of Part II, discusses in some detail the issue of attributing a credit rating to a PE and concludes, for banks and similar financial enterprises, that under the WH, the same credit rating is attributed to a PE as is enjoyed by the enterprise as a whole. This conclusion will apply equally for non-financial institutions.

(e) Documentation

166. The WH would also apply, by analogy, the guidance on documentation in Chapter V of the Guidelines. In particular, the same standards would apply to the documentation of dealings as currently apply to the documentation of transactions and the summary of recommendations at paragraphs 5.28 and 5.29 of the Guidelines should be followed. No particular conceptual difficulties in applying this guidance in the PE context are envisaged. Indeed, many of the problems of obtaining information from outside the jurisdiction of the host country that arise in the associated enterprise situation would not arise in the PE context. For example, it is the same legal entity that is the taxpayer in both the host and the home jurisdiction. Information outside the jurisdiction of the PE, such as information from the Head Office, is under the control of the same taxpayer. This contrasts with the associated enterprise situation, where the equivalent information might not be under the control of the subsidiary, but might be held by a separate legal entity, the parent company. In short, in the PE context, information in the home jurisdiction should be readily available to the host jurisdiction and vice versa.

167. However, as dealings have not always been recognised for the purposes of attributing profits to PEs, taxpayers may not be in the habit of documenting dealings to the same extent as they would transactions with associated enterprises. This may explain some of the potential difficulties in applying the WH in practice that have emerged from the testing process. It may therefore be necessary for tax

administrations to educate taxpayers in this matter so as to ensure that dealings are in fact adequately documented in accordance with the guidance in Chapter V of the Guidelines. Tax administrations and taxpayers should also follow the general guidance in Chapter V on these issues.

D. Interpretation of paragraph 3 of Article 7

168. In attributing profit to a PE in accordance with the arm's length principle, regard must be given to the wording of Article 7(3), which provides that:

“In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.”

169. Article 7(3) is open to varying interpretations, and the Member countries have considered a range of possibilities. The perspectives on Article 7(3) tend to focus on two competing interpretations. One interpretation is that the provision is aimed primarily at ensuring expenses of a PE's activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the PE's jurisdiction, or is not incurred exclusively for the PE. The other view is that Article 7(3) modifies the arm's length principle articulated in Article 7(2), in that (1) costs allocable to a PE should be deductible even if they exceed what an arm's length party would incur, and (2) another part of the enterprise cannot recover more than its costs with regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties. In analysing these positions, regard has been given to the history of Article 7(3); to the original intent of the provision; to the practice of Member countries in applying the provision; and the views of Member countries as to the ideal role of the paragraph.

170. The history of Article 7(3) would tend to support the view that the original intent of the provision was simply to ensure that relevant expenses would be deductible against the income of a PE, and that no conflict with the arm's length principle was intended. Indeed, it appears from the history that Article 7(3) was not intended to modify the arm's length principle. Questions about the allocation of profit for head office activities were specifically mentioned in the League of Nations draft of 1933, many years prior to the origin of Article 7(3), so the issue was certainly known and could have been articulated in connection with the issuance of Article 7(3) had that been the intent. However, when Article 7(3) makes its first appearance in the 1946 League of Nations London Model, the expressed purpose is unrelated to the profit issue: “There are indeed in most enterprises with two or more establishments, certain items of expenses that must necessarily be apportioned in order to achieve the object of separate accounting, which is to place branches of foreign enterprises on the same footing as domestic enterprises.”

171. Subsequently, the historical grounding of Article 7(3) was somewhat confused by efforts to address the profits attribution question in the 1963 Draft Commentary to the OECD Model Tax Convention. That Draft Commentary discussed aspects of the profit attribution issue under the caption of Article 7(3). The question addressed was whether the deductions allowed in computing the profits of a PE for particular kinds of expenses (e.g. internal “interest” and “royalty” payments) should be the actual costs incurred or arm's length prices. However, paragraph 14 of the Commentary qualifies that: “it is convenient to deal with them here”, presumably because the general discussion on allocating expenses is found under the same heading. The original version of paragraph 13 of the Commentary demonstrates the limited role intended for Article 7(3): “This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. *It is valuable to include paragraph 3 if only for the sake of removing doubts* (emphasis added).” The wording of Article 7(2) was then changed in the

1977 OECD Model Tax Convention so as to make it: “subject to paragraph 3”. This change helped create the misleading impression of a conflict of principle between Article 7(2) and Article 7(3).

172. The changes made in the Model Commentary in March 1994 tried to clarify the intention of Article 7(3) by stating in paragraph 17 that: “there is no difference in principle between the two paragraphs”. It then went on to say that Article 7(2) should not be interpreted as requiring: “that prices between the permanent establishment and head office be normally charged on an arm’s length basis whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual costs of those expenses.” Unfortunately, the language from paragraph 14 of the 1963 Model (“it is convenient to deal with them here”) referring to the placing of the discussion, was lost in the changes.

173. In sum, it appears that the original intent of Article 7(3) was to ensure that expenses of a PE’s activity could be deductible against a PE’s attributed profits regardless where incurred (in the jurisdiction of the PE, of the head office or of another part of the enterprise). The original drafting does not appear to have contemplated a modification of the arm’s length principle. However, given the wording of the Model Commentary and the proviso “subject to paragraph 3” that has been included in Article 7(2), it is possible to interpret Article 7(3) otherwise. In particular, the practice of some Member countries has been to interpret Article 7(3) to provide the two modifications to the arm’s length principle of Article 7(2), namely that: (1) costs allocable to a PE should be deductible even if they exceed what an arm’s length party would incur, and (2) another part of the enterprise cannot recover more than its costs with regard to expenses incurred for the purpose of the PE, unless those expenses relate directly to dealings with third parties.

174. Most Member countries, including those that interpret Article 7(3) as requiring the above-named modifications to the arm’s length principle, believe that it would be preferable if Article 7(3) did not result in modifications to the arm’s length principle. Accordingly, the working hypothesis is that the role of Article 7(3) should be just to ensure that the expenses of a PE’s activity are not disallowed for inappropriate reasons, in particular, because the expense is incurred outside the PE’s jurisdiction, or is not incurred exclusively for the PE. It will be noted from the discussion of Article 7(2) that the working hypothesis does not mandate an attribution of profit (see paragraph 123 above). Furthermore, the working hypothesis only determines which expenses should be attributed to the PE. It does not go on to determine whether those expenses, once attributed, are deductible when computing the profit of the PE. That will be determined under the domestic law of the host country.

E. Interpretation of paragraph 4 of Article 7

175. The OECD Model Tax Convention contains in Article 7(4), another provision for attributing profits to a PE:

“Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.”

176. There is concern that the language of Article 7(4) does not require the use of the purely transactional profit methods authorised by Chapter III of the Guidelines and nor does it follow the hierarchy of methods outlined in that Chapter, as profit methods are allowed if customary, rather than as a last resort. Additionally, Article 7 (4) refers to “an apportionment of the total (added emphasis) profits of

the enterprise to its various parts” and could therefore only be transactional in nature if the total profits to be split could be aggregated from individual transactions in accordance with the principles set out by Chapter I, Part C (iii) of the Guidelines. This is very unlikely unless the PE carries on the full range of activities conducted by the whole enterprise or the enterprise itself only carries on a single activity.

177. However, there are safeguards against too widespread an adoption of the Article 7(4) approach. The Model Commentary at paragraph 25 makes clear that such a method is:

“not as appropriate as a method which has regard only to the activities of the permanent establishment and should only be used where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory.”

178. This would appear to prevent it being applied by countries who have not used such methods to date or in new business areas. There also is an implication in the above language, which is borne out by the historical background, that the use of Article 7(4) has only become customary in areas where it has not proved possible to apply the distinct and separate enterprise approach of Article 7(2). The Model Commentary also makes clear at the end of paragraph 25 that in bilateral treaties the provision “may be deleted where neither State uses such a method.”

179. The approach described by Article 7 (4) is also distinguishable from the global formulary apportionment method rejected by Chapter III of the Guidelines. This is because the last sentence of the provision makes clear that the result of an apportionment under Article 7(4) should be in conformity with the other principles in the Article. These include, amongst other things, the arm’s length principle, as applied to PEs by Article 7(2). However, the fact that an attribution under this provision starts off from an attribution of total profits means that, in practice, it may be very difficult to achieve such a result.

180. Given the above caveats, its possible use in a very small number of cases should not weaken the commitment to transactional methods contained in Chapters II and III of the Guidelines. However, the Member countries are of the opinion that such an apportionment method is not consistent with the guidance on the arm’s length principle in the Guidelines, or that it is extremely difficult to ensure that the result of applying that method is in accordance with the arm’s length principle. Member countries are also of the opinion that methods other than an apportionment of total profits could be applicable, even in the most difficult cases. Accordingly, the working hypothesis is that only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE. A possible exception to the above conclusion, relates to the attribution of profit to a PE of an enterprise carrying on an insurance business. The Steering Group intends to test the proposition that (given that under the WH only paragraphs 1, 2 and 3 of Article 7 are needed to determine the attribution of profits to a PE) there is no continuing need for Article 7(4).

F. Interpretation of Paragraph 5 of Article 7

181. Another example where there are problems in applying the “functionally separate entity” approach in the special situation of an enterprise carrying on its business through a PE, is described by Article 7(5) of the OECD Model Tax Convention, which prohibits an attribution of profit to a PE “by reason of the mere purchase of goods or merchandise for the enterprise.” The Model Commentary at paragraph 30 states that the provision is concerned with a PE that “although carrying on other business, also carries on purchasing for its head office.” The Model Commentary makes clear that all profits and expenses that arise from the purchasing activities will be excluded from the computation of taxable profits.

182. This does not necessarily accord with the situation that would occur where one independent enterprise “merely purchases” goods or merchandise on behalf of another independent enterprise. In those

circumstances the purchaser would be remunerated on an arm's length basis for its services as a purchasing agent of the other enterprise. There also is a practical problem in deciding which expenses of the PE relate to the purchasing activities and so should be excluded. In addition, it is not clear why the restriction on attributing profits in Article 7 (5) is limited to the case where the PE merely purchases goods or merchandise. There seems little difference in principle if, instead of purchasing goods or merchandise, the PE carries on another of the activities mentioned in Article 5(4), such as the collection of information, which are not sufficient by themselves to create a PE.

183. Member countries of the Steering Group are of the opinion that Article 7(5) is not consistent with the arm's length principle and is not justified. The WH is that there is no need to have a special rule for "mere purchase". There should be no limit to the attribution of profits to the PE in such cases, apart from the limit imposed by the operation of the arm's length principle.

PART II: SPECIAL CONSIDERATIONS FOR APPLYING THE WORKING HYPOTHESIS TO PERMANENT ESTABLISHMENTS (PEs) OF BANKS

A. Introduction

1. Part I of this report describes how to apply the working hypothesis (WH) to a permanent establishment (PE) for the purposes of testing the application of the WH in general. However, it is also considered necessary to supplement this general advice with more specific and practical guidance in order to assist the testing of the application of the WH in commonly occurring factual situations. This Part of the report looks at the banking sector and discusses how the WH might apply to a number of factual situations commonly found in enterprises carrying on a banking business through a PE. The starting point for this analysis is naturally the 1984 OECD Report, "Transfer Pricing and Multinational Enterprises - Three Taxation Issues; The Taxation of Multinational Banking Enterprises" ("1984 Report").

2. However, there have been considerable changes in the global economy since 1984, which have affected the way multinational banks carry on business. There also have been changes in thinking about the application of the arm's length principle, reflected most notably in the revision of the OECD Transfer Pricing Guidelines started in 1995 ("the Guidelines"). This report is therefore intended not only to update the issues and situations described in the 1984 report but also to deal with particular issues and situations arising from the widespread financial liberalisation and globalisation of financial markets which have been such a feature of the global economy in the late 20th Century. For example, while risk has always been of significant concern to banks, technological developments in the late 20th Century have resulted in the ability and willingness of banks to undertake pro-active risk management as a means of maximising shareholder wealth and of dealing with risk-based capital adequacy requirements.

3. This part of the report considers what might be called traditional banking activities, the borrowing and on lending of money and provides guidance on how the income from such activities (most often interest or interest equivalents) might be attributed to a PE of a banking enterprise. In this Report, the term "interest" is intended to have a broad meaning in order to encompass a wide range of receipts and payments in the nature of business profits earned by a bank from the borrowing and lending of money. Other financial activities carried on by banks, such as the global trading of financial instruments, are dealt with in Part III of this report - such activities are also commonly carried on by financial institutions other than banks.

B. Factual and functional analysis of a traditional banking business

4. This section analyses the most important functions of a traditional banking business (i.e. the borrowing and on-lending of money) both in terms of the functions performed when creating a financial asset (a loan) and the subsequent functions performed over the life of the financial asset. Following the approach in Chapter I of the Guidelines, the analysis of functions performed also takes into account the assets used and risks assumed in performing those functions.

B-1 Functions performed

(i) Functions involved in creating a new financial asset - a loan

5. For the negotiation and conclusion of a traditional banking transaction leading to the creation of a financial asset (a loan), the following functions would normally need to be performed by the enterprise as a whole (not necessarily in the order set out below):

- a) Sales/Marketing - e.g. cultivating potential clients, creating client relationships and inducing clients to start negotiating offers of business;
- b) Sales/Support (preliminary stage) - e.g. evaluating credit risk for the new business, establishing creditworthiness of client, checking overall credit exposure of bank to a client;
- c) Sales/Trading - e.g. negotiating the contractual terms with the client, - deciding whether or not to advance monies and, if so, on what terms, deciding what levels of credit, currency and market risk to accept, pricing the loan, considering whether collateral or credit enhancement is needed and committing the bank (and its capital) to the loan, etc.;
- d) Trading/Treasury - e.g. taking deposits, raising the funds to enable loans to be made on the most advantageous terms, making the funds available; and
- e) Sales/Support (contractual stage)- e.g. checking draft contracts and completing the contract formalities, resolving any outstanding legal issues, checking any collateral offered, signing the contract, recording the financial asset in the books and disbursing the loan proceeds.

(ii) Functions involved in managing an existing financial asset - a loan

6. Once a financial asset (a loan) has been created, the following functions would normally need to be performed by the enterprise as a whole over the life of the asset (not necessarily in the order set out below):

- a) Loans support - e.g. administering the loan, collecting interest when due, monitoring repayments, checking value of any collateral given;
- b) Monitoring risks assumed as a result of entering into the loan- e.g. reviewing credit rating of client, monitoring overall credit exposure of the client to the bank, monitoring interest rate and position risk, analysing profitability of loan and return on capital employed, reviewing efficiency of use of regulatory capital, etc.;
- c) Managing risks assumed as a result of entering into the loan - e.g. deciding whether, and if so, to what extent various risks should continue to be borne by the bank, e.g. by transferring credit risk to a third party by means of credit derivatives or hedging interest rate risk by purchase of securities, reducing overall risk by pooling individual risks and identifying internal set-offs and actively managing the residual risks retained by the bank, e.g. by hedging residual risks or by leaving risk positions open in the hope of benefiting from favourable market movements, etc, deciding write-offs for non-performing loans;
- d) Treasury - e.g. managing the banks overall funding position (funding deficits or investing surpluses in the market), including managing the interest rate risk and liquidity rate risk exposures of the bank, allocating the costs of funds raised by the bank as a whole to branches/business units, matching

duration of borrowing with lending, and maximising efficiency of employment of regulatory capital and return on capital employed;

- e) Sales/trading - e.g. refinancing the loan, deciding to sell or securitise loan, marketing to potential buyers, pricing loan, negotiating contractual terms of sale, completing sales formalities etc, deciding whether to renew or extend the loan and, if so, on what terms.

(iii) *Other functions*

7. The functions outlined above are those most directly related to the creation, and subsequent management, of a loan. However, as with all enterprises a certain infrastructure is necessary to support those functions, often centralised in the head office. Most of those functions, general management, setting of business strategies, development of computer systems, research, personnel functions etc are not confined to banking operations. Such functions are sometimes classified either as “back office” or as “middle office” functions, with “back office” functions being seen as generally adding less economic value to the business and so deserving a lower reward. Perhaps an area of particular significance to a bank are the functions relating to the supervision of the management of the bank’s overall capital and risk exposure. Banks normally have committees which set risk limits on a cascading basis - there will be a limit for overall risk for the bank, an overall limit for different types of risk (e.g. credit risk) and limits for particular business lines etc.

B-2 *Assets used*

8. The Guidelines note at paragraph 1.20 that compensation will usually reflect not just functions performed but also the assets used and risks assumed in performing those functions. So the functional analysis will have to consider what assets are used and what risks are assumed in creating, and subsequently managing, a loan. For banks, the most important assets used are financial assets, such as loans, cash, reserves and other liquid investments. These assets are “used” by the bank to generate gross income in the form of interest and interest equivalents.

9. Banks also use physical assets such as branch premises, computer systems etc and so the functional analysis will have to consider which non-financial assets are used by the PE. Section C-1 (ii) of Part I of this Report provides some guidance in this area. These may need to be taken into account in making any comparability analysis under the second step of the WH. For example, retail internet and telephone banking services are cheaper than branch based services partly because they do not need a physical retail branch network to distribute their products and so use less of expensive physical assets (such as branch premises).

10. Further, as with any other business, the functional analysis should also examine whether any intangible assets have been used. In the banking area a common intangible is likely to be the marketing intangible represented by the name, reputation, trademark or logo of the bank. Other intangibles would be more akin to manufacturing intangibles, such as proprietary systems for maximising efficient use of regulatory capital and for monitoring various types of risk. Moreover, these intangibles are of particular relevance to financial firms as they reflect the importance of measuring and optimising use of capital and of monitoring and managing financial risks in the financial sector.

11. The importance of capital in supporting the operations of a banking business raises the issue of how to deal with capital when undertaking a functional analysis (taking into account assets used and risks assumed). The issue of capital is linked inextricably with the issue of risk assumption. Banks cannot assume material additional risk without affecting their credit rating unless there is a corresponding increase

in their capital. The amount and nature of the risks assumed therefore plays an important part in determining the amount of capital a bank requires. It is suggested therefore that for banks and other financial institutions, a functional analysis should be undertaken taking into account assets used and risks assumed in the same manner as a functional analysis would be undertaken for non-financial institutions. The analysis of risks assumed would include an examination of the issues related to capital adequacy and allocation of capital that are likely to be of particular significance for banks and other financial institutions.

B-3 Risks assumed

12. In a banking business, a proper evaluation of “risks assumed” is of prime importance. Banking, like other financial businesses, is based on taking on (assuming) risks from customers. In a banking business, the creation of a loan involves the assumption of a number of different types of risk by the bank, of which the following have traditionally been considered the most important for tax purposes;

- a) Credit risk - the risk that the customer will be unable to pay the interest or to repay the principal of the loan in accordance with its terms and conditions,
- b) Market interest rate risk - the risk that market interest rates will move from the rates used when entering into the loan. Market risk can arise in a variety of different ways depending on the nature of the interest rate on the lending and on the borrowing. For example, the borrowing could be fixed but the lending floating or even if both the lending and borrowing are floating there could be a mismatch in timing. Interest rate risk can also arise due to the behavioural effects of market movements on the bank’s customers. For example, a decline in interest rates will encourage customers to prepay fixed-rate loans.
- c) Market foreign exchange risk - the risk that where the loan is made in a currency different from the domestic currency of the bank (or the currency of the borrowing) that the exchange rate will move from the rates used when entering into the loan.

13. It should be noted that there are also other types of risk, such as country risk and legal/settlement risk, which may be of importance in particular situations. Further, the Basel Committee on Bank Supervision announced recently that it was considering extending its review of risks that require minimum capital requirements to include interest rate risk in the banking book and operational risk. These developments will need to be closely monitored to ensure that all significant risks for tax purposes are adequately taken into account when performing a functional analysis.

(i) Credit rating

14. A bank’s credit rating is an important factor to be taken into account in any transfer pricing analysis as it affects both the bank’s ability to borrow, the rate at which it can do so and the gross margin that can be earned. Generally, and in the absence of deposit insurance, the credit rating of a bank is inversely related to the interest rate it pays to its investors (its depositors and holders of its debt instruments). The higher the credit rating of the bank the lower the interest rate it pays to its investors. This is because investors demand a risk premium for investing their money in order to reflect the risk of not getting back the full amount of the investment and the investment return when due. The risk premium represents the additional return (in the form of a higher interest rate) that the investor expects to receive as compensation for investing in a riskier bank (e.g. one with a AA credit rating) rather than investing on the same terms in a safer bank (e.g. one with a AAA credit rating).

15. A credit rating is the perception by an independent party, a rating agency, of the likelihood that a company will meet its commitments in respect of any borrowings it has made and investments it has received. A number of factors are taken into account, the amount of regulatory and “free” capital of the bank obviously being an important factor. Other relevant factors include a solid reputation and a history of consistently high profitability. Certain types of “niche” business are restricted to banking entities with the highest credit rating (e.g. some borrowers will only transact with AAA rated counterparties).

16. Importantly, a credit rating is assigned by the agency to the bank as whole and not to individual branches (either directly by evaluating the bank itself or indirectly by assigning a credit rating to the banking group that is treated as applying to all its members). As for capital, this reflects the fact that potentially the whole of the bank’s assets and capital are available to meet any claims on the bank regardless of where the asset leading to the claim is located.

(ii) *Capital adequacy requirements*

17. In order to assume material amounts of the risks already described without adversely affecting its credit rating, the bank requires “capital”, i.e. the ability to absorb unanticipated losses due to the realisation of assumed risks, for example the realisation of assumed credit risk when a customer defaults and does not repay the full amount of the loan. Importantly, to protect customers, and to maintain the integrity of the financial system, banks are regulated by Governments and are required to have minimum amounts of regulatory capital (regulatory minimum capital) based on the risks they assume in conducting business. This is an area in which there have been significant developments since the 1984 Report was issued (see next paragraph).

18. The Basel Committee on Bank Supervision (the Basel Committee) is the body that sets internationally accepted standards for capital adequacy, see the July 1988 publication, “International Convergence of Capital Measurement and Capital Standards”(the 1988 Basel Accord). The 1988 Basel Accord sets minimum levels of capital to cover credit risk for internationally active banks while permitting national authorities to adopt arrangements that set higher capital levels. There have been a number of amendments to the 1988 Basel Accord with by far the most significant being the January 1996 “Amendment to the Capital Accord to Incorporate Market Risks” (the 1996 Market Risk Amendment). In this report, unless otherwise stated, a reference to the 1988 Basel Accord means the original document together with all subsequent amendments.

19. Regulatory capital is classified into different Tiers of capital, based broadly on the permanency of the capital invested. The most permanent capital is Tier 1 capital and consists of items such as paid-up ordinary shares, non-repayable share premiums, reserves and retained earnings, non-cumulative and non-redeemable preference shares. Tier 2 capital includes items such as subordinated debt instruments and long-dated debt. One other matter of interest is that in calculating Tier 1 capital a deduction is normally made for capital invested in affiliated banks in order to discourage the banking system as a whole from creating cross-holdings of capital rather than drawing capital from outside sources. However, there are certain circumstances in which some regulators will allow the capital in such subsidiaries to be counted for regulatory purposes as belonging to the parent bank. This matter is considered in more detail in paragraph 81 in the context of attributing capital to the PE.

20. Capital adequacy requirements are calculated by dividing the bank’s capital base by the total risk weighted assets of the bank (including “off-balance sheet” exposures) to produce a capital ratio (the Cook ratio). The assets are weighted to take into account both credit and market risk. The minimum requirement set by the Basel Committee is that total capital must be equal to at least 8% of the total risk-weighted assets

of the bank. Out of the total capital, Tier 1 capital must be at least equal to 4% of the total risk-weighted assets of the bank.

21. In general, for financial accounting purposes Tier 1 capital is “free” capital, i.e. it does not result in any interest cost, whilst Tier 2 capital does. So in computing the bank’s profit for accounting purposes it is only the return on Tier 2 capital invested that will be deducted. The treatment for tax purposes may not follow accounting treatment. Although the return on Tier 1 capital does not result generally in any tax deduction (it is “free” capital for tax, as well as accounting, purposes), there may be some instruments that qualify as Tier 1 capital and also are treated as debt for tax purposes in some jurisdictions. Such instruments are being issued with increasing frequency. Further, in a number of jurisdictions, the return on some Tier 2 capital such as subordinated debt may be treated as “free” capital for tax purposes.

22. The corollary of the above situation is that in order to create a financial asset the bank must have sufficient regulatory capital available (including “free” capital) to meet the minimum capital requirements of the regulatory authorities. Broadly, if the bank does not have enough regulatory capital available it will be unable to enter into a loan without adversely affecting its credit rating or breaching bank regulations. To avoid an adverse impact on its credit rating and to avoid regulatory intervention, the bank could reduce the risk of holding the asset, for example by disposing of it to a securitisation vehicle and investing the proceeds in less risky assets.

(iii) Other regulatory requirements

23. As well as setting minimum capital adequacy requirements, regulatory regimes may also prescribe other restrictions. For example, they may require that regulatory capital be invested in certain assets considered to be “safe”, such as government bonds, or that banks maintain mandatory reserves in the form of deposits at the central bank. Banks would prefer to employ their capital in their own loan assets which potentially yield higher returns and so there is an “opportunity cost” caused by regulation. Further, this opportunity cost varies according to the particular regulatory regime; some jurisdictions are stricter than others in terms of setting minimum amounts of regulatory capital, reserve requirements and investment restrictions etc. Accordingly, regulatory capital is a scarce resource for a bank and so must be “used” as efficiently as possible in order to ensure that the bank can create and retain the most profitable financial assets on its books.

24. The business drive to maximise regulatory efficiency may cause financial assets to be booked in the most advantageous location for regulatory purposes (“regulatory competition”). Such competition can arise, for example, through differences in regulatory minimum reserve requirements between jurisdictions. Consequently, the jurisdiction in which a financial asset is booked need not be the same jurisdiction in which any of the functions necessary to create the asset were performed or need not be the same jurisdiction in which the functions needed to maintain the asset are currently performed. Banks may also undertake regulatory arbitrage and take advantage of different capital requirements of the banking or trading book, perhaps by using credit derivatives. Regulatory capital requirements may also make it too expensive to hold some types of assets on the bank’s balance sheet, leading to the development of securitisation techniques.

25. Regulatory competition and arbitrage create a problem for both taxpayers and tax administrations, as the results of such competition or arbitrage may mean that an asset is not necessarily booked in the jurisdiction in which most of the profits related to that asset are in fact earned. In such cases, the financial accounts of the bank may require considerable adjustment in order to accurately reflect where profits have been earned for tax purposes.

(iv) *Significance of “free” capital*

26. Banks attempt to earn gross profits from lending transactions by ensuring that they receive more interest from lending funds than they pay in interest costs to obtain the funds. Provided the gross profits exceed the other costs of making and maintaining the loan (e.g. the costs of performing the functions described above), the bank will make a net profit. One way a gross profit margin can be achieved is by the bank borrowing the funds at a lower interest rate than the rate it charges the customer for a loan. There are a number of ways it can do this, for example by borrowing short-term funds and lending those funds on longer terms in order to take advantage of the interest rate yield curve (short-term funds are usually cheaper than long-term funds) or by having a higher credit rating than the customer (see sub-section (i) above).

27. If all the funds lent to the customer are borrowed, the bank’s expected gross profit margin will be an interest rate differential that reflects the functions performed by the bank taking into account any assets used and risks assumed (for example the yield curve or credit risk referred to in the previous paragraph). The expected gross profit margin can be improved if not all of the funds lent to the customer are borrowed. This requires the bank to use some of its own financial resources that do not require the payment of interest - its “free” capital. Funds from retained profits and funds from issuing shares are the commonest forms of “free” capital. The amount of “free” capital will have a large impact on the potential profit a bank can make and the amount of tax it will pay. The matter has therefore been of considerable interest to tax authorities. The particular significance in the PE context is discussed in Section D - 1 (iii).

C. Banks operating through subsidiaries

28. It is not believed that there are any particular problems with applying the Guidelines to banking transactions between associated enterprises. The functional and factual analysis of a banking enterprise provided in Section B is applicable both to banking activities conducted between associated enterprises and to banking activities within a single legal enterprise. Further, the guidance in Section D on how the Guidelines can be applied, by analogy, to attribute profit to a bank PE also provides useful guidance on how to apply the Guidelines to banking activities more generally. This analysis and guidance should enable taxpayers and tax administrations to apply appropriately the guidance in the Guidelines to banking transactions between associated enterprises.

D. Applying the WH to banks operating through a PE.

29. Part I of this report describes how to apply the WH to a PE for the purposes of testing the application of the WH in general. This Part discusses how to apply the WH to a PE of a bank for the purposes of testing the application of the WH to banks. The approach taken is to describe in Section D-1 how the WH would apply generally to banks, paying particular attention to how the transfer pricing concepts of functional and comparability analyses necessary to apply both the steps of the WH can be applied, by analogy, to a bank PE. Section D- 2 discusses in detail how this general guidance would apply to specific situations commonly found in the banking sector.

D-1 First step: determining the activities and conditions of the hypothesised distinct and separate enterprise

30. It is necessary under the first step of the WH to hypothesise the PE as a distinct and separate enterprise “engaged in the same or similar activities under the same or similar conditions.” As explained in Part I of this Report (see Section C-1) this will be determined by a thorough functional and factual analysis

to identify the economically significant activities and responsibilities undertaken by the enterprise as a whole, before going on to identify which of those economically significant activities and responsibilities are undertaken by the PE, and to what extent. While taxpayers may book assets in a particular jurisdiction with a view to gaining a tax advantage, the results of such booking practices should not be respected where they are inconsistent with this functional analysis. Section B provides a brief general functional and factual analysis of traditional banking activities, i.e. the borrowing and lending of money which should assist in carrying out the functional and factual analysis of a banking enterprise.

31. Having identified the functions performed and other relevant factors of the enterprise in relation to traditional banking operations, the next step under the WH is to determine which of those functions are performed by the PE and what assets are used and what risks are assumed as a result of performing those functions. For a bank, capital adequacy (especially “free” capital) and credit rating are likely to be particularly important as both affect the profitability of the bank, for example by affecting the compensation a bank would have to pay to independent parties for providing funds to the bank. This section only discusses areas where it is considered further guidance is needed on how to apply the general guidance in Part I of this Report to a bank PE.

(i) *Attributing functions to the PE*

32. Looking at the description of the functions necessary to create a new financial asset, or to subsequently manage that asset, at paragraphs 5 and 6 above, it can be seen that all of the functions are performed by personnel: “people functions”. So the functional analysis should be able to determine which of those functions are performed by the PE by looking at whether the people performing those functions are located in the PE. However, it may also be necessary to determine whether some of the functions described at paragraph 7 above, although performed outside the PE, should nevertheless be taken into account when attributing profit to the PE as being related to, at least in part, the functions and characteristics of the PE. This will be determined by applying the general guidance on services in Part I of this Report. The application of this general guidance to the banking context is discussed in section D-2 (iii)(d) below.

33. Tax issues arise particularly where the functions involved in the creation and management of an asset are performed in more than one location, a “split function business”. The significance of this issue can be seen when determining, under the second step of the WH, an arm’s length compensation for the performance of the different functions. For example, if all the functions listed at paragraphs 5 and 6 were performed by the PE, there would be little to take into account under the second step of the WH (other than the functions referred to in paragraph 7), unless there was a change of circumstances and other parts of the enterprise started to perform some of the functions of managing the asset discussed later in section D-2(iii)(b). However, where the functional analysis shows that some of the functions leading to the creation of the new financial asset were performed by other parts of the enterprise, those are “dealings” between the PE and the other parts of the enterprise which will have to be taken into account under the second step of the WH (discussed later in section D-2 (iii)(a)(1) and (iii)(a)(2) below).

34. As well as analysing each of the functions performed by the PE in detail, it is also necessary to consider what assets are used and what risks are assumed in performing those functions. In terms of assets used, the most important intangibles used in a banking business have already been identified in paragraph 10 above. It is not considered there are any problems particular to banking which require guidance beyond the general guidance already given in Part I of this report. In terms of risks assumed, it is the performance of the sales/trading functions that lead to the initial assumption of the greatest risks (credit risk, operational risk and market risk). It is then the responsibility of the risk management function to ensure that the assumed risks are successfully managed. Consequently, it is the undertaking of the sales/trading and risk

management functions that creates the possibility of significant loss for the bank and the need for minimum regulatory, including “free”, capital. For the other functions, the risk of loss relates only to the costs of the personnel involved, e.g. the time spent by a marketer on potential client who never becomes a customer of the bank.

(ii) *Attributing a credit rating to the PE*

35. As discussed earlier, the ability to borrow at one rate of interest and to lend at another, higher, rate is fundamental to the business of a banking enterprise. The credit rating of the banking enterprise is, in turn, a crucial factor in the ability to raise funds at a rate that enables the enterprise to make a “turn” and therefore a profit on its activities. This is because the credit rating of an enterprise is a significant factor in determining the lender’s perception of credit risk involved in making a loan to that enterprise, a perception that translates into the interest rate charged.

36. The importance of the credit rating can be illustrated by means of an example (please note the figures in the following example are illustrative only). Assume that an AAA rated bank can borrow for 3 years at rate of 4.95%; an enterprise rated AAA can borrow for 3 years at a rate of 5.05%; and an AA rated bank can borrow for 3 years at a rate of 5.1%. In the normal course, a branch of the AAA rated bank (because it relies on the credit rating of the whole bank) could borrow at 4.95% and lend for exactly the same 3 year term to a AAA enterprise at 5.05%, making a profit of 0.10%.

37. Conversely, assume the branch is a legally distinct and separate banking enterprise, with a credit rating less than that of the parent bank, say a rating of AA. Now it can only “borrow” at 5.1%. Its AAA customer will not pay more than 5.05% for a 3 year loan, which would leave the branch with a loss of 0.05% if it borrowed the funds to on-lend for the same 3 year term (NB. The AA rated bank could lend at an expected profit to the AAA rated enterprise but only by taking advantage of the yield curve and borrowing the funds for a shorter period, say 6 months, than the 3 year term of the lending (see paragraph 22 above). This would leave the lender exposed to yield curve risk, i.e. the risk that short-term interest rates would have risen at the end of the 6 month period, thereby making it prohibitively expensive to re-finance the loan.)

38. In fact, bank branches enjoy the same credit rating as the enterprise as a whole, which enables them to borrow and on-lend at a profit on the same terms. To postulate that Article 7 requires that the branch should not enjoy that credit rating, but should be treated as having a lower rating than the enterprise as a whole, would produce an unrealistic, perhaps perverse, attribution of profit.

39. There is consensus, therefore, that the hypothesised distinct and separate enterprise should have the same credit rating as the bank as a whole. Although countries agree on the result, their analyses differ.

40. Some consider that the above result is wholly consistent with the WH as currently stated. The result flows from the functional and factual analysis under the first step of the WH. It is a fact that third parties, credit agencies etc., do not perceive a PE as having a separate credit rating from the bank as whole. This is no doubt based in part on the fact that potentially the whole of the bank’s assets and capital are available to meet any claims against the PE. If the functional analysis shows that the hypothesised distinct and separate enterprise is lending funds to customers with the same credit rating as the bank as a whole then as the example above illustrates, the PE must be hypothesised with the credit rating necessary to perform those functions. That is, it must be hypothesised with the same credit rating as the bank.

41. Others consider that this result naturally flows from the way the PE is hypothesised as a distinct and separate enterprise. The PE is bound to have the same credit rating as the bank as a whole because, under the WH, the capital of the bank is attributed “harmoniously” to the hypothesised distinct and

separate enterprise (the PE) based on the risks it assumes. So if the PE takes on more risk than other parts of the enterprise, it has more capital attributed to it so that the residual risk exposure, and therefore the credit rating, remains proportionally the same as the rest of the enterprise. Accordingly, under the arm's length principle, the PE would be found to have the same credit rating as the whole bank, as indeed would all the PEs of the bank and the head office.

42. Others have suggested that the guidance in Chapter VII of the Guidelines provides justification for attributing to the PE the same credit rating as is enjoyed by the enterprise as a whole. The issue is that of "active" and "passive" association and paragraph 7.13 notes that:

"For example, no service would be received where an associated enterprise by reason of its affiliation alone has a credit-rating higher than it would if it were unaffiliated, but an intra-group service would usually exist where the higher credit rating were due to a guarantee by another group member, or where the enterprise benefited from the group's reputation deriving from global marketing and public relations campaigns. In this respect, passive association should be distinguished from active promotion of the MNE group's attributes that positively enhances the profit-making potential of particular members of the group."

43. However, this raises the question of how far the PE, as a hypothesised enterprise, could be said to be only passively associated with the credit rating of the hypothetical enterprise making up the rest of the bank. The credit rating of a bank is of vital importance in determining the profitability of its lending and whether it can lend to certain clients at all. This is reflected in the efforts of banks to promote and enhance their credit ratings. It is not thought that the guidance in Chapter VII can satisfactorily resolve this issue.

44. Yet others have suggested that the credit rating be viewed as an "internal" condition of the enterprise which should be treated as an "internal" condition of the PE. The desired result would follow because the credit rating of the bank as a whole (as an "internal" condition of both the enterprise and the PE) would automatically be given to the PE. However, it is not yet clear on what basis the credit rating should be regarded as an "internal" condition of the PE (see section C-1 (iv) of Part I). Others, while accepting that the same credit rating is an "internal" condition of the enterprise, do not view this result as a clear outcome of the application of the WH and point out that this is a subset of a broader issue regarding the handling of risks under the WH.

45. Clearly, all these approaches have merit, and since they all lead to the same conclusion, it is unnecessary to definitively endorse one approach as the preferred approach for the WH. The Steering Group therefore considers that in such a way that the same credit rating is attributed to the PE as is enjoyed by the enterprise as a whole.

(iii) *Attributing "free" capital to the PE*

46. Section B-3 (iv) discussed the general significance of "free" capital for a bank. The subject is even more significant for the taxation of a bank PE. Unlike payments to equity holders, interest payments to holders of debt capital are generally tax deductible. Therefore, in order to arrive at an arm's length attribution of taxable profit to the PE, it will be necessary to ensure an appropriate allocation to the PE of the equity ("free") capital of the enterprise as a whole. This section considers how to determine the arm's length amount of "free" capital that should be attributed to the PE. The next section considers how to adjust the interest expense claimed by the PE to an arm's length amount (including making adjustments for the attribution of "free" capital²² determined in accordance with the guidance in this section).

47. The regulatory system for banks is based on world-wide regulation of the consolidated banking group by the home country. This regulation aims, amongst other things, to ensure that the consolidated

banking group as a whole maintains an adequate amount of capital to cover the business it takes on and the risks it assumes from its world-wide operations by requiring that adequate capital be maintained at every tier within a banking group. For these purposes, the whole capital of each bank in the consolidated banking group is taken into account, regardless of where it is located, because its whole capital is potentially available to meet losses in respect of any asset of that bank. Provided the home country bank regulators follow the Basel standards, the bank regulators in the PE jurisdictions will ordinarily not attempt to determine capital adequacy levels for the bank or, importantly, insist on separate minimum capital requirements for the PE.

48. Consequently, for regulatory purposes in both home and host jurisdictions, there is no need for any “free” capital to be formally allotted or endowed to the PE and so its operations (unlike those of the bank itself) could be wholly debt funded. However, if the same banking operations were carried on through a subsidiary in the host jurisdiction, the regulatory authorities would insist on minimum capital requirements, including Tier 1 capital, which is largely “free” capital. If the tax authorities followed the regulatory approach, which is indifferent as to whether any capital is attributed to branches, the branch would be much more lightly taxed than the subsidiary because of the absence of “free” capital. The following example may help to illustrate this point.

Example (please note the figures are for illustration only)

Midas Bank (a resident of Country B) conducts banking operations in Country A (local currency \$) and lends \$100 to a third party customer at 10.2%. Midas Bank can borrow \$100 in market of Country A at 10%.

Situation 1: Midas Bank operates through a branch in Country A

Country B’s regulators follow the Basle Committee Standards and ensure that Midas Bank fulfils the minimum capital adequacy requirements. Accordingly, the regulators in Country A do not insist on the branch of Midas Bank in Country A maintaining any separate minimum regulatory capital. The Midas Bank branch has no “free” capital” allotted to it and so its operations are wholly debt funded producing the following gross profit margin for accounting purposes:

	Interest received	=	100 * 10.2%	=	10.2
	Less Interest paid	=	100 * 10.0%	=	<u>10.0</u>
Gross profit margin					0.2

Situation 2: Midas Bank operates through a subsidiary in Country A, Midas Ltd

Midas Ltd is regulated by Country A’s regulators who also follow the Basle Committee Standards and ensure that Midas Ltd fulfils minimum capital adequacy requirements based on its global activities. Accordingly, the regulators in Country A insist that the Midas Ltd maintains a minimum capital ratio of 8% of which 4% must be Tier 1 Capital (it is assumed that this is all “free” capital under the tax rules of A).

Calculation of interest paid:

It is necessary to calculate the amount of the “free” capital which is needed to support the lending. Let us assume that the loan of \$100 is given a risk weighting under the regulatory rules of 50%.

“free” capital (Tier 1) is set by regulators at 4% of risk weighted assets. So for the loan of \$100 with risk weighting of 50%, the amount of “free” capital must be 4% of 50 = 2. So the bank will only have to

borrow \$98 the remaining \$2 must be “free” capital and is interest free. This produces the following gross profit margin for accounting purposes:

	Interest received	=	100 * 10.2%	=	10.2
	Less Interest paid	=	98 * 10.0%	=	<u>9.8</u>
Gross profit margin					0.4

So the gross profit margin of the subsidiary, Midas Ltd, is double that of the Midas Branch for the same banking transaction simply because of regulatory differences permitting it to operate without “free” capital.

49. It is suggested that the above result should not be followed for tax purposes. It is unacceptable on tax policy grounds - the result is not neutral between residents and non-residents (it favours non-residents), does not follow the arm’s length principle and produces a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations. The latter provides considerable scope for tax avoidance. A potential solution to the above problem is discussed in this section, which considers how to attribute the “free” capital of the bank to the PE under the WH.

50. As noted in paragraph 48 above, the regulatory focus on the consolidated banking group means that there may be no need to allocate any capital to the PE for regulatory purposes. This should not however affect the attribution of capital for tax purposes. Consequently, an arm’s length attribution of capital to the PE may have to be made to ensure an arm’s length attribution of taxable profit to the PE, even though no capital has actually been allocated to the PE for regulatory or other purposes.

51. The starting point for attributing the “free” capital of the bank is to attribute the assets of the bank. Following the analysis at paragraphs 8 and 32 above, the assets of the bank are initially attributed by reference to a functional analysis, based on where the assets are used. For the financial assets of the bank this will be based on where the sales/trading function leading to their creation were performed. Where the functional analysis has determined that the PE alone has performed the sales/trading function, the PE will be attributed the newly created financial asset. However, where the functional analysis shows that sales/trading functions leading to the creation of the asset are performed partly in one jurisdiction and partly in another, these “dealings” will need to be taken into account in the second step of the WH in order to determine how to attribute that asset to more than one part of the enterprise. This issue is discussed in detail in section D-2 (iii)(a)(2) below.

52. Events subsequent to the creation of the asset may also affect where the asset is attributed for the purposes of capital allocation and may lead to the asset being wholly or partly attributed to another part of the enterprise. Subsequent transfers of assets initially attributed to a PE would lead the asset to be wholly attributed to another part of the enterprise, provided those transfers are recognised for tax purposes following the guidance given in section D-2 (iii)(c) below. Further, the attribution of assets would also have to take into account any subsequent events leading to the asset becoming jointly owned. For example, where significant functions, such as risk management, are transferred such that the asset should be treated as jointly owned by the parts of the enterprise that created the asset and the parts of the enterprise that subsequently manage the risks associated with that asset (see section D-2 (iii)(b) below). In such cases, the asset would be treated as partly attributable to the part of the enterprise that created the asset and partly attributable to the part of the enterprise that is performing the risk management functions.

53. Having attributed assets to the PE on the basis outlined above, the next step is to determine the amount of “free” capital needed to support those assets. The WH is to make this determination in accordance with the arm’s length principle. This requires that capital needs to be allocated taking into account both the nominal value of the asset and the value of the various risks inherent in that asset. The first step is therefore to risk weight the assets already attributed to the PE. The second step is to allocate

sufficient capital to the PE to support its risk-weighted assets. This process is consistent with the arm's length principle, as independent enterprises would need to allocate more capital to riskier assets.

54. A promising possibility for achieving this aim would be to use, as a proxy for the arm's length principle, the independently set and internationally accepted regulatory benchmarks of the Basel Committee. In particular, the "standardised" approaches for determining minimum capital requirements have the potential to be adapted so as to approximate an arm's length attribution of capital in most situations. The various possibilities, including the standardised approaches, are discussed in this section before a conclusion is drawn as to the most reliable and administratively feasible approach to allocate the capital of a bank to a PE under the arm's length principle.

a) Step 1 - Risk weighting assets

55. The 1988 Basel Accord⁵ has the potential to be used to attribute risk weighted assets to a PE as it seeks as a first step to weight the bank's assets for credit risk. Further, since the adoption in January 1996 of the amendment to incorporate market risks, the Basel Accord can now be used to weight the bank's assets for market risk. Such an approach has the advantage of providing an internationally consistent measure, which should make it easier for host and home country to agree on the appropriate risk weightings and thereby greatly reduce the risk of double taxation.

56. However, one disadvantage is that the current regulatory benchmarks for weighting assets for credit risk under the 1988 Basel Accord are somewhat crude. For example, credit risks are divided for weighting purposes into only 5 categories; 0, 10, 20, 50 and 100%. The way the categories are currently drawn up also leads to some odd results - the same degree of credit risk is effectively given to a loan to a AAA counterparty as to an individual buying a car. In that sense the current regulatory benchmarks would only be a proxy for an arm's length approach, although some of the apparent problems may be reduced because the individual scorings are averaged over a large number of assets. Indeed, given the large number of assets usually involved in a banking business, a certain degree of approximation is inevitable. Further, other types of risk such as operational risk and interest rate risk in the banking book are not included in the risk weighting.

57. Encouragingly, the regulatory authorities are aware of some of the rough edges in the current approach and the Basel Committee released in June 1999 a proposal to improve matters by retaining the existing Accord as the "standardised (credit risk) approach" but modifying it to improve its accuracy. Greater emphasis will be placed on a proper assessment of the risks involved in banking operations in addition to credit and market risk, for example by developing a standardised capital charge for interest rate risk in the banking book and for other risks, principally operational risk. The current proposal of the international regulatory community to retain the "standardised (credit risk) approach" but to modify it to improve its reliability is therefore most welcome and holds out the prospect of a more accurate, as well as internationally acceptable, method for measuring risk in accordance with the arm's length principle.

58. However, there are regulatory developments that raise tax issues worth further consideration. One regulatory development that has already occurred concerns the use of the bank's internal models for measuring market risk. The January 1996 Market Risk Amendment provides for two ways of measuring market risk. The first is a "standardised (market risk) approach" that determines minimum capital charges for "general" and for "specific" market risk. The second is based on following the bank's internal "value at risk" models, provided the models are deemed suitable by the regulatory authority and the bank's risk

5. International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision (July 1988).

management systems are satisfactory. Unlike the “standardised (market risk) approach”, the internal models take into account the correlative effects of positions within or across risk categories.

59. The June 1999 proposal to modify the 1988 Basel Accord also opens up the possibility of allowing approaches other than the “standardised (credit risk) approach” to measure credit risk. In particular, it may be possible in the future to use banks’ internal credit risk models to measure credit risk on a portfolio basis, based on either external or internal credit rating assessments.

60. The use of models based on a portfolio approach to measuring risk, rather than one based on an evaluation of the risks for individual assets, raises issues regarding the application of the WH. This is because the WH is based on determining the risk weighting for the individual assets attributed to a particular PE based on the functional analysis and on the premise that the PE is a hypothetical distinct and separate enterprise.

61. A regulatory approach applied on a portfolio basis would not attempt to assign risk weightings to certain types of individual assets at all and so there might not be any regulatory data available at the PE level for those types of assets. Further, the risk calculations undertaken for regulatory purposes would allow internal set-offs and risk correlation with assets in the same portfolio held by other parts of the same enterprise.

62. Further work will be needed once the deliberations of the Basel Committee on this issue have been completed and final regulatory guidance has been issued.

63. In conclusion and subject to the next paragraph, the “standardised” approaches of risk weighting assets under the 1988 Basel Accord seems to be an acceptable and fairly reliable proxy for the arm’s length principle and has the advantage of providing an internationally accepted and consistent way of measuring risk. Regulatory developments to maintain and improve the reliability of the standardised (credit risk) approach have the potential to provide an even more accurate method of measuring credit risk and so provide a more reliable proxy for the arm’s length principle. Regulatory developments that are not based on the “standardised” approaches, such as using the bank’s own risk measurement models, have the potential to provide more accurate measures of credit and market risk and so more accurately reflect the arm’s length principle. However, such methods have the potential disadvantage that, unlike the standardised approach, they may not yet be readily accepted by all countries as valid for tax purposes. It is suggested that such matters should be resolved under the Mutual Agreement Article and that both host and home jurisdictions should accept the use of approaches other than the standardised approach, provided that they are consistent with the arm’s length principle.

64. Moreover, it should be borne in mind that the WH is to risk weight assets in accordance with the arm’s length principle, rather than to follow regulatory approaches for risk weighting. Regulatory developments will need to be carefully monitored to ensure that any changes do not affect the reliability of the regulatory approach as a proxy for determining an arm’s length risk weighting of the financial assets attributed to a bank PE.

b) Step 2 - Determining the capital needed to support the risk weighted assets attributed to the PE

65. Having risk weighted the assets attributed to the PE, the next step is to determine how much capital is needed to cover that risk under the arm’s length principle. The Steering Group has considered three possible approaches, which are discussed below.

66. One possibility would be to require the PE to have at least the same minimum amount of capital required for regulatory purposes (regulatory minimum capital) as would an independent banking enterprise

operating in the host country jurisdiction (a quasi thin capitalisation approach). The regulatory minimum capital would include a minimum amount of Tier 1 capital, which is largely “free” capital, determined in accordance with the regulatory standards of the host jurisdiction.

67. A second possible approach would be to require that the PE has the same amount of capital (including “free” capital) as would independent banking enterprises carrying on the same or similar activities under the same or similar conditions in the jurisdiction of the PE (a thin capitalisation approach). However, this raises the issue of what is meant by “same or similar”. The branch when hypothesised as a separate enterprise would be smaller than the bank as a whole and so would be compared with similarly small independent banking enterprises. However, small independent banks may not be comparable to a PE that is part of a large banking enterprise. They are likely to carry on different types of business, to have different risk profiles and to have different types of customers than the PE to which they are being compared. In short, small independent banks may not be a reliable benchmark to use for attributing capital to such a PE.

68. A third possible approach would be to attribute the bank’s regulatory capital in accordance with the attribution of risk on the basis of the proportion that the risk weighted assets of the PE bears to the total risk weighted assets of the entity as a whole (the BIS ratio approach). So if the PE has 10% of the bank’s risk weighted assets, it will have attributed to it 10% of the bank’s regulatory capital.

69. Of particular significance for tax purposes, is that the regulatory capital so attributed will include 10% of the bank’s Tier 1 capital and so will provide the PE with “free” capital (see paragraph 21). This attribution of the bank’s “free” capital should ensure that the PE has sufficient “free” capital to satisfy the arm’s length principle under Article 7(2), and should eliminate the potential for discrepancy in the profits made for similar banking operations conducted through branches rather than subsidiaries (see example at paragraph 48 above.)

70. This approach differs from the quasi-thin capitalisation approach as more than the regulatory minimum amount of capital may be attributed to the PEs of the bank. The effect of allocating only the regulatory minimum is that any capital in excess of that amount is effectively allocated to the head office. However, it will be necessary to properly attribute the total capital of the bank, and not just the regulatory minimum, if the BIS approach is to be used as a proxy for the application of the arm’s length principle. This is on the basis that all the assets and all the associated risks of the bank (including extraordinary and unforeseeable risks) have been attributed to the various parts of the bank, including the head office, under the functional analysis. Given a functionally based and risk weighted asset allocation, there is no reason to allocate part of the regulatory capital of the bank to head office on the basis that the head office would be expected to absorb any extraordinary and unforeseeable risks once such materialise. It would be the part of the bank to which those assets had been attributed that would be expected to assume those risks and absorb any losses using the regulatory capital attributed to it. The amount of regulatory capital so attributed should of course reflect the “riskiness” of the particular assets.

71. Further, for commercial reasons, banks are likely to include in their regulatory capital not just “free” capital but also other types of semi-permanent interest bearing capital such as subordinated debt. Investors require a higher return on such debt to reflect the restrictions on such debt as compared to conventional debt. This raises the issue of how to take into account such debt when applying the arm’s length principle.

72. One way would be to use the BIS ratio of the whole bank to attribute both Tier 1 and Tier 2 regulatory capital to a PE (the “pure” BIS ratio approach). This method means that the PE necessarily has proportionately the same composition of regulatory capital as the whole bank - the ratio obtained by comparing the risk weighted assets of the PE to the total risk weighted assets of the entity as a whole is

applied to attribute both Tier 1 and Tier 2 regulatory capital. Under this approach, the capital attribution would include instruments that are both debt and equity for tax purposes.

73. For example, suppose the capital of the bank was made up of 60% Tier 1 capital (40% ordinary share capital and 20% retained profits) and 40% Tier 2 capital (30% subordinated term debt and 10% subordinated perpetual debt). Under the “pure” BIS ratio approach, if the risk weighted assets of the PE were 10% of the risk weighted assets of the enterprise as a whole, the PE would be attributed 10% of the capital of the bank. That is it would be attributed with 10% of all the items making up the Tier 1 and Tier 2 capital of the bank (i.e. 4% of the ordinary share capital, 2% of the retained profits, 3% of the subordinated term debt and 1% of the subordinated perpetual debt).

74. The debt/equity characterisation rules of the PE’s jurisdiction would then be applied to “cleanse” the attributed Tier 1 and Tier 2 capital and determine which items would qualify for an interest deduction and which would be treated as “free” capital for tax purposes under the domestic laws of the host jurisdiction. For example, the “interest” on the 1% of the bank’s subordinated perpetual debt attributed to the PE might not be allowed as a deduction in the jurisdiction of the PE because subordinated perpetual debt is treated as equity for tax purposes in that jurisdiction and so any “interest” on such instruments would be disallowed. It is noted that debt/equity characterisation rules for financial instruments may vary from country to country and that such variation may result in double, or less than single, taxation. While less variation in such rules between jurisdictions may be desirable, it is not appropriate to address this issue in the WH. This issue is of wider significance and is not confined to PEs.

75. A number of Steering Group member countries already apply a BIS ratio approach that uses BIS ratios to attribute only the “free” capital in Tier 1 to a PE (the “cleansed” BIS ratio approach).

76. Using the same example as in paragraph 73 above, the first step under the "cleansed" BIS ratio approach, is to apply the debt/equity characterisation rules used for tax purpose in the PE's jurisdiction to the Tier 1 and Tier 2 capital items of the enterprise as a whole. This would determine ("cleanse") which items would be treated as "free" capital for tax purposes under the domestic laws of the host jurisdiction. For example, the subordinated term debt and the subordinated perpetual debt might be characterised as debt instruments for tax purposes in the host jurisdiction and so would not be treated as “free” capital that needed to be attributed to the PE. If the risk weighted assets of the PE were 10% of the risk weighted assets of the enterprise as a whole, the next step is to attribute to the PE 10% of the "free" capital items of the bank (i.e. 4% of the ordinary share capital and 2% of the retained profits). It is worth stressing that under this approach, there would be no attribution to the PE of a proportionate share of any Tier 1 or Tier 2 capital items characterised as debt under the debt/equity characterisation rules used for tax purpose in the PE's jurisdiction.

77. It should be stressed that the goal of both the “pure” and the “cleansed” BIS ratio approaches is the same. Both approaches are attempting to ensure that the amount of interest expense (defined according to the classification rules of the host jurisdiction) claimed by the PE does not exceed the arm’s length amount. Consequently, the overall result of applying either approach should be similar.

78. However, to achieve similar results, it will be necessary to examine the interaction between the method of attributing “free” capital to the PE and the method for determining an arm’s length interest rate in respect of interest “dealings” by the PE. This is discussed further in Sections D-1(iv) and D-2 (iii) a)(1)(ii).

79. Another point that needs consideration is the basis of the capital adequacy return which the regulatory authorities require from a bank for the purpose of ensuring compliance with minimum capital requirements. Most commonly, banking groups are required to submit a return on a “consolidated” basis,

encompassing the banking entity itself and all relevant affiliates. However, a return on a “solo” basis, applying to the banking entity only, may be required. Moreover, if certain conditions are met, the regulatory authorities may allow the banking entity to modify its “solo” return in order to include capital invested in “solo-consolidated” subsidiaries (a “solo-consolidated” basis).

80. General tax principles are based on respecting the separate legal entities within a multi-national group. Those principles therefore suggest the WH should be applied so as to attribute to a PE only the regulatory capital of the banking entity of which the PE is a part (a “solo” basis). This basis would exclude from allocation any capital held in the subsidiaries of the banking entity. For jurisdictions where the regulator does not require return prepared on a “solo” basis, the WH would require information as to the regulatory capital of the “solo” entity just for tax purposes. This is not thought to be too burdensome an imposition as such information should be readily available.

81. However, the Steering Group has not come to a firm conclusion on all the consequences of following a “solo” basis for determining the total amount of capital that can be attributed. **Comments on these issues from the public would be particularly welcome.**

c) Alternative approaches to capital allocation

82. The focus of the “quasi thin capitalisation” approach is on providing an administratively simple way of ensuring that the PE cannot have less capital than a regulated banking subsidiary operating in the same jurisdiction. This approach is not however consistent with the WH because it is not based on an application of the arm’s length principle under Article 7(2). Problems may arise where the PE would be attributed less capital than the regulatory minimum under the arm’s length principle, for example where the PE invests only in very safe assets. In such cases, double taxation may arise because the home country would restrict the profits of the PE qualifying for double taxation relief, to reflect the lower amount of capital necessary under the application of the arm’s length principle. Such concerns are less where the approach is applied as a safe harbour so that the taxpayer is given the opportunity to demonstrate that the PE actually requires less “free” capital than the regulatory minimum for an independent banking enterprise in the PE’s jurisdiction.

83. Under a thin capitalisation approach, it is perfectly possible for either more, or less, capital than the enterprise as a whole possesses to be attributed amongst its various parts. In practice, banks often carry on riskier business outside their home jurisdiction and so the PE, when hypothesised as a legally distinct and separate enterprise, is likely to be require more capital than independent banking enterprises operating in the same jurisdiction in order to cover the riskier activities it undertakes. Double, rather than less than single, taxation of the bank’s capital is more likely to occur under a thin capitalisation approach.

d) Conclusion on attributing capital to the PE

84. The allocation of capital among parts of an enterprise involved in a banking business is a pivotal step in the process of attributing profit to a bank PE. It determines the quantum of capital that the bank PE should be considered to have under the WH and the appropriate treatment of Tier 1 and Tier 2 capital under the tax rules of the PE’s jurisdiction. This reflects the accepted view that a bank PE, just like any other type of PE, should have sufficient “free” capital to support the functions it undertakes, the assets it uses and the risks it assumes. For this reason, the manner with which capital is allocated if double taxation is to be avoided or minimised is an important step.

85. Relative to the other two possible approaches considered above, an obvious advantage of a BIS ratio approach over the thin capitalisation approach is that it should greatly reduce the risk of double, or

less than single, taxation by removing the need to determine separately the debt/equity ratio of the hypothesised distinct and separate enterprises and for both the host and home country to agree on that measure. However, an issue arises as to whether the advantage of the BIS ratio approach has been achieved at the expense of the arm's length principle. One interpretation of that principle would require the PE to have a comparable debt/equity ratio to independent enterprises in the jurisdiction of the PE performing comparable functions, using comparable amounts of assets, assuming comparable amounts of risk (e.g. credit, market, etc.) and imposing comparable amounts of default risk on third party creditors.

86. Given its conceptual foundation, the BIS ratio approach is considered capable of providing a valid proxy for the arm's length principle and produce a result that would not differ significantly from the application of a thin capitalisation approach. There might be instances where a marked divergence would be observed between the two approaches, for example where the PE conducts a very different type of business to the bank as a whole or the market conditions in the PE are very different from those applying to the rest of the bank. In such cases, it may be necessary to revert to methods (e.g., a thin capitalisation approach) that would more reliably produce a result that is consistent with the arm's length principle. However, the BIS ratio approach should generally produce an appropriate result and the use of a universal standard provides many advantages over alternative methods.

87. Accordingly, the WH should recognise that a BIS ratio approach (that may be modified from time to time to take into account developments at the Basel Committee) is the most appropriate approach currently available to attribute the capital of a bank to a PE in accordance with the arm's length principle. However, regulatory developments will have to be monitored in order to ensure that such an approach, as it evolves over time, remains the most reliable and appropriate approach.

88. As noted in Part I of this Report (section C-2 (iv)(d)), some countries of the Steering Group consider that it would be preferable to apply a thin capitalisation approach because they consider this method more in accordance with the arm's length principle and the "functionally separate entity" approach preferred under the WH. They also see some merit, on grounds of administrative simplicity, of using a quasi thin capitalisation approach as a safe harbour and feel that the difficulties of applying a thin capitalisation approach in practice have been overstated. Further, they have concerns over the operation of the BIS ratio approach and particularly the approach of attributing the total capital of the enterprise, rather than just the regulatory minimum amount. They consider that amounts in excess of the regulatory minimum need to be retained in the home jurisdiction in order to cover losses from unforeseen and exceptional events.

89. Finally, as reflected above, there is consensus within the Steering Group that a bank PE, just like any other type of PE, should have sufficient "free" capital to support the functions it undertakes, the assets it uses and the risks it assumes. It is hoped that the process of public consultation will assist in the development of a single internationally accepted method for making that attribution of "free" capital.

(iv) *Adjusting the interest expense claimed by a PE*

90. Once the arm's length amount of "free" capital attributed to a PE has been determined a comparison needs to be made with the actual "free" capital allotted to the PE by the bank. Where the amount of "free" capital allotted by the bank is less than the arm's length amount, an appropriate adjustment will need to be made to reduce the amount of interest expense claimed by the PE in order to reflect the amount of the bank's "free" capital that is actually needed to support the lending activities of the PE. The adjustment will be made following the rules of the PE's jurisdiction. Some possible means of making this adjustment are discussed in Section C-2(iv)(d) of Part I and are equally applicable to banks.

91. One particular issue related to banks is how to deal with the interest bearing debt in Tier 2 capital that carries a higher interest rate than debt that is not subordinated. This is because it will be necessary to take into account any “dealings” related to the raising of subordinated funds by the enterprise, in order that the PE can deduct the right amount of interest expense. For example, if Tier 2 subordinated debt is raised by one part of the enterprise, it would not be correct to leave this part of the enterprise with all the interest expense in respect of debt that was raised for the benefit of the bank as a whole without it receiving an arm’s length compensation for the treasury function performed. Although such matters are dealt with in general under the second step of the WH (see Section D-2(iii)(a)(1)(ii)), it is convenient to deal with the subordinated debt issue here. Member countries of the Steering Group have different approaches to address this issue.

92. Under one approach, there will be no need to make an adjustment because the higher interest rate will have been reflected appropriately in the calculation of the rate on any internal “interest” dealings. Funds raised by the bank are from a variety of sources and have varying interest rates. Some funds are free or give rise to very low interest rates, whilst others give rise to high interest rates, such as subordinated debt qualifying as Tier 2 capital. So if, for example, any internal “interest” dealings are charged at an appropriately “blended” rate to reflect the proportions of funding at different interest rates and maturities, there should be no need to make further adjustments to arrive at an arm’s length interest expense for the PE (other than in the circumstances addressed in paragraph 90).

93. Another approach would proceed first by attributing free capital in Tiers 1 and 2 to the PE under the “cleansed” BIS ratio approach. Then, the analysis in D-2(i) (Recognition of dealings) would be applied to identify any dealings related to a movement of funds between different parts of the enterprise, such as a treasury dealing. Under the second step of the WH, the arm’s length price for such dealing would be determined, by analogy, in accordance with the Guidelines. Section D-2(iii)(a)(ii) provides further guidance on how to determine an arm’s length compensation for such dealings. As noted at paragraph 91 above, the interest expense of the PE may need adjusting, such as where the PE has been attributed insufficient “free” capital. Under the approach described in this paragraph, no further consideration would be given to the underlying costs of the “lender” in the dealing, such as any high interest rate cost on any subordinated debt qualifying as Tier 2 capital, since that would already be taken into account as the result of the attribution of “free” capital and the arm’s length price for that dealing (see paragraph 78 of Part I). Accordingly, a specific allocation of interest-bearing Tier 2 capital need not be made because it is already taken into account through the impact it has, combined with all other borrowing rates of the enterprise, on the profits and losses and retained earnings that form a part of Tier 1 capital that is available for attribution to the PE, and on the arm’s length price for the dealing.

94. Another approach would be to apply the pure BIS ratio approach to determine the amount of the bank’s Tier 2 capital that is actually needed to support the lending activities of the PE. An adjustment will then have to be made to increase the interest expense claimed by the PE on the amount of Tier 2 capital attributed to it. This will be made by reference to the market interest rates for such Tier 2 capital, following the rules of the PE’s jurisdiction. **Public comments on the approaches described in this section are invited including whether they lead to consistent results.**

D-2 Second step: determining the profits of the hypothesised distinct and separate enterprise based on a comparability analysis

95. As noted in Part I of this Report, the functional and factual analysis of the first step of the WH will have appropriately hypothesised the PE and the rest of the bank as associated enterprises, each undertaking functions, using assets and assuming risks. Further, as noted above, other important

characteristics (e.g. “free” capital and credit rating) will also have been appropriately hypothesised to the PE and the rest of the bank.

96. The second step of the WH goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (“dealings”) between the hypothetical enterprise and the rest of the bank. In particular, the concept of comparability analysis will be used in order to attribute profit in respect of those “dealings” by making a comparison with transactions undertaken between independent enterprises.

97. General guidance on making such comparisons has been provided in Section C-2 (ii) of Part I of this report. This section discusses how to apply that guidance to a bank PE involved in the borrowing and lending of money.

(i) *Recognition of dealings*

98. As noted in Part I of this Report, the guidance at paragraphs 1.28-1.29 and paragraphs 1.36-1.41 of the Guidelines can be applied, by analogy, to determine whether a dealing has taken place and whether the dealing as structured by the taxpayer can be disregarded or re-characterised. It will be necessary first of all to determine whether any dealing exists in relation to the PE before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm’s length attribution of profit. In terms of the threshold question, Part I of this Report goes on to note that a dealing should not be found between different parts of the enterprise unless it relates to “a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.)” that has transpired between them. The paragraph concluded that, “A functional analysis should be used to determine whether such an event should be taken into account as an inter-branch dealing of economic significance.”

99. It is considered relatively straightforward to apply the above guidance to dealings related to the provision of services within a bank. This is discussed in more detail in section D-2 (iii)(d) below.

100. However, there are more problems when trying to apply that guidance to dealings in relation to financial assets, given the nature of a traditional banking business. A bank’s stock in trade is its financial assets - its loans. However, such assets are not physical in the sense that they exist only as contractual arrangements and as entries in the accounting records of the bank. Unlike a physical asset, it can be difficult to determine where in a bank the financial assets are located, and, once located, whether they have been transferred to another part of the enterprise or whether another part of the enterprise has begun to use them. These difficulties are compounded by the impact of regulation which can mean that assets are “booked” in a location where none of the functions related to the creation, or ongoing management, of that asset have been, or will be, carried out (see sections B-3 (ii) and (iii)).

101. The WH relies on the functional analysis to determine where assets are used, to determine a change of use and so determine whether there are any dealings to be taken into account for the purpose of attributing profit. Assets are not “used” where they are booked, if none of the functions related to that asset have been performed there. Therefore, an accounting entry removing the asset from the books of one PE and transferring it to the books of another part of the enterprise would amount to a “dealing” unless the transfer was not accompanied by a transfer of related functions and the transfer of the assumption of the profit and risk potential of the asset. See Section D-2 (iv) where the transfer of the asset results from the performance of an agency or conduit function.

102. As noted in section C-2 (ii) of Part I of this Report, where an examination of the conduct of the parties shows that the terms of the “dealing” were not followed so that there was no real transfer of related functions or of the risk or profit potential of the asset, the transfer of the asset would be viewed as a sham

and so would be ignored for tax purposes. Similarly, transferring where an existing asset is booked, without transferring any of the functions and profit and risk potential of the asset would not result in a change of use of that asset or any dealing in respect of that asset.

103. The situation is more complex because the functions and risks associated with financial assets can sometimes be disaggregated so that functions are performed and risks managed by more than one part of the enterprise. For example, some, but not all of the functions related to the management of the risks of an existing financial asset could be transferred to another part of the enterprise. In that case there may be dealings to be potentially taken into account or the asset might be treated as being “owned” jointly by more than one part of the enterprise. This is discussed in further detail in this section below on split functions (sub-sections iii(a)(1) and (a)(2)), management of an existing financial asset (sub-section iii(b)) and transfers of financial assets (sub-section iii(c)).

104. Once the above threshold has been passed and a dealing recognised as existing, the WH applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. This means that, except in the 2 circumstances outlined at paragraph 1.37, tax administrations “ should not disregard the actual *dealings* or substitute other *dealings* for them.” Practical issues related to the valuation of internal dealings may arise, especially where market data is not available, although such difficulties may also occur in respect of the valuation of transactions between associated enterprises. Further, some members of the Steering Group are still considering whether the WH, as currently expressed, provides sufficient protection against tax motivated transfers through internal hedging arrangements.

(ii) *Applying transfer pricing methods to attribute profit*

105. Having established that a dealing has taken place and that the dealing as structured by the taxpayer would not need to be disregarded or re-characterised the next issue is to determine whether the profit attributed to that dealing by the bank is at arm’s length. This is done by applying the guidance in the Guidelines on comparability, by analogy, in the bank PE context. This is done by making a comparison of the reward earned from *dealings* within the bank with comparable *transactions* between independent enterprises, having regard to the 5 factors for determining comparability set out in Chapter I of the Guidelines.

106. Further, the WH provides that all the methods in the Guidelines can be applied in the PE context in order to determine the profit to be attributed in respect of the dealing by reference to comparable uncontrolled transactions. In the first instance, the traditional transaction methods should be examined to see if comparables from uncontrolled transactions are available. In this context, the guidance at 2.7, 2.14 and 2.34 should be borne in mind where differences are found between the dealing and the uncontrolled transaction under respectively the CUP, resale price and cost plus methods. As noted, at paragraph 2.7, “The uncontrolled transaction may be comparable, “if one of two conditions is met: 1. none of the differences (if any) between the transactions (*in the PE context between the uncontrolled transaction and the dealing*) being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or 2. reasonably accurate adjustments can be made to eliminate the material effects of such differences.”

107. A traditional banking business involves the borrowing and lending of money. Money is a global commodity and so there are likely to be few problems with applying the first of the comparability factors: the characteristics of property or services, where traditional financial assets such as loans or bonds are used. Nevertheless, as stated in paragraph 1.19 of the Guidelines, "(d)ifferences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market." Characteristics that may be important to consider in relation to financial assets include the

following: the principal involved, the term of the financial asset, the applicable interest (discount) rate, the currency in which the financial asset is denominated, the respective rights of the parties in the event of default, etc. If there are no other differences in the other factors it should be relatively straightforward to find comparables and apply traditional transaction methods using market data. However, it may be difficult to find comparables for more exotic financial instruments and for instruments used for dealings that involve internal hedging arrangements.

108. The second factor, functional analysis, raises more issues. Even where there may be few product differences, there may be considerable differences in the nature of the functions performed, especially risks assumed in relation to the “dealings”. Such dealings may be structured in a different way from the way transactions between independents are structured. For example, the performance of related functions may be split between different parts of the enterprise, whilst such functions would always be performed together by independents, so making it difficult to evaluate the dealings in isolation and apply reliably any of the traditional transaction methods. Such problems occur with increasing frequency in transactions between associated enterprises and Chapter III of the Guidelines approves other methods (transactional profit methods) to be applied in situations where the traditional transaction methods of Chapter II cannot be applied reliably. The section below on split functions examines the application of transactional profit methods to a bank PE in more detail.

109. With regard to the third comparability factor, contractual terms, no particular conceptual difficulties are envisaged in the banking area, although there may be practical difficulties due to the lack of contemporaneous documentation or other evidence of the intention of the parties etc. The general guidance in Part I of this report should be followed in order to determine the division of responsibilities, risks and benefits between the parties to the dealing.

110. In some countries, internal dealings are often not well documented and this gives rise to the issue of how to determine the terms of any dealing. However, associated enterprises also do not always document transactions and this issue is covered by the guidance in paragraph 1.28 of the Guidelines. That guidance can be applied, by analogy, by equating “terms of the dealing” with “contractual relationships.” Consequently, “Where no written terms exist, the *terms of the* relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.”

111. This determination should be made very thoroughly because of the paramount importance of determining the true division of risks when attributing profits from banking dealings to a PE. This is because of the close relationship between expected profits and risks assumed in a banking business. This issue is discussed in further detail in relation to 2 types of common bank dealings; agency or conduit dealings and transfers of financial assets.

112. One issue will be of particular importance when applying the general guidance on the fourth comparability factor (economic circumstances) to attribute profit to a bank PE. That is the impact of regulation, especially different regulatory regimes as discussed in section B above. Following the guidance at paragraph 1.30 of the Guidelines, different bank regulatory regimes should be considered as potentially affecting market comparability. For example, it would not be correct to treat market data from a less regulated market as comparable to dealings in a more regulated market, without making reasonably accurate adjustments for those regulatory differences.

113. It is not considered that there are any particular difficulties in applying the general guidance on the final comparability factor (business strategies) to attribute profit to a bank PE. Any relevant business strategies should be taken into account and should have been determined by the functional and factual analysis under the first step of the WH.

114. The discussion above is based on the comparison of individual dealings with individual uncontrolled transactions. In practice, a banking business usually consists of a large number of similar financial assets and dealings. Accordingly, it may be particularly appropriate to apply the guidance on aggregating transactions at 1.42 of the Guidelines in the banking context. For example, a comparability analysis could be made between suitably aggregated dealings and suitably aggregated uncontrolled transactions such as a portfolio of closely linked and similar loan assets.

115. Having discussed in general terms how to apply the second step of the WH to attribute profit to a bank PE, the next sub-section looks at some specific, and commonly occurring, situations in more detail.

(iii) *Traditional banking business*

116. Where, following the functional and factual analysis, it is found that the PE is engaged in a traditional banking business, i.e. acting as a borrower and a lender of money, a number of potential tax issues arise in respect of how to reward the performance of those functions and any related “dealings” between the PE and the rest of the enterprise. This sub-section discusses those functions and dealings in detail (with the exception of agency or conduit functions and dealings which are discussed in section D-2(iv) below).

a) *Functions involved in creating the financial asset*

117. The first step of the WH will have determined which parts of the enterprise have undertaken the functions listed at paragraph 5 above necessary to create the financial asset. If all the functions necessary to create the loan were performed by the PE, there should be little difficulty in determining an arm’s length reward for the performance of those functions. Any transactions related to the performance of the functions will have been conducted directly by the PE and so should be at arm’s length prices, either by definition, because they are conducted with independent enterprises, or by application of the usual transfer pricing rules if conducted with associated enterprises.

118. It would still be necessary to consider making an adjustment to the amount of interest paid to third parties to reflect the amount of the bank’s “free” capital that is needed to support the lending activities of the PE, following the guidance given in section D-1 (iv) above. It should also be noted that there may also be some attribution issues in relation to other functions not related to the creation of the asset, such as the subsequent management of that asset and the provision of general support and an appropriate infrastructure e.g. centralised Head Office functions. These are discussed in later sections.

119. However, more commonly, the first step of the WH will have shown that some of the functions leading to the creation of the new financial asset were performed by other parts of the enterprise (split functions). Those functions represent “dealings” between the PE and the other parts of the enterprise which will have to be taken into account under the second step of the WH in order for the PE to receive an arm’s length attribution of profit. The following sub-sections analyse these split function dealings in detail.

1) *Split function business: sales/trading functions in one location*

120. This sub-section looks at the situation where the sales/trading function has been performed by only one part of the enterprise but some of the other functions related to the creation of the financial asset have been performed by different parts of the enterprise. In this case, the PE is the “owner” of the asset and will receive the associated interest income and bear the costs of financing the asset etc. The cost of financing the asset will be determined having regard to how the required funds were obtained by the PE.

For example, where the PE raises the required funds itself in the local market, the cost of financing the asset would be the borrowing cost in the local market. Where the PE engages a specific branch of the bank to raise the required funds, the discussion on agency or conduit functions in Section D-2 (iv) provides relevant guidance. Where the PE obtains the required funds from the treasury of the bank, or from another part of the bank not acting as an agent or conduit, the discussion in Section D-2 (iii)(a)(1)(ii) provides relevant guidance.

121. However, other functions may have been performed by other parts of the enterprises for the “owner” of the asset and these represent “dealings” that need to be taken into account, for example by means of an arm’s length service fee. The situation where the sales/trading function has itself been split is dealt with in sub-section (a)(2) below.

122. In these circumstances, the question arises as to how to attribute an arm’s length profit to the PE. The functional analysis under the first step of the WH will have determined which part of the enterprise has performed the various functions mentioned in paragraph 5. For example, it may be the case that although the sales/trading function leading to the creation of the asset have been performed by one PE, the asset was created as a result of the customer having been referred to the PE by another branch. The performance of these functions needs rewarding, provided that, as would normally be the case, independents performing the same functions would expect to be rewarded.

123. The performance of the functions, other than sales/trading functions, outside of the PE will be characterised as “dealings” between the PE and the rest of the enterprise. Comparisons will be sought between these “dealings” and transactions between independents. All the methods approved in the Guidelines are available to make this determination, starting with the traditional transaction methods described in Chapter II.

i) Sales and support functions

124. The application of the arm’s length principle to the performance of sales and support functions related to a global trading business were discussed in some detail in Sections III- 2 and III - 3 of the Global Trading Report. It is considered that this guidance applies equally to the sales and support functions of a banking business listed in paragraph 5 above, although there may be fewer situations where the sales or support functions are as integrated either with other functions or between different locations. This means that it should be possible in more cases to use the traditional transaction methods of Chapter II of the Guidelines to attribute profit in respect of “dealings” related to these functions and market data from brokers and back-office service companies may be available. Further, no special difficulties are seen in applying the general guidance of the WH to equate, for the purposes of comparability analysis, “dealings within an enterprise” with “transaction between associated enterprises”.

ii) Treasury functions and internal movement of funds/ “interest” dealings

125. Treasury dealings are such an important part of any banking operation, it is considered important to briefly discuss how to apply the WH to the performance of treasury functions and to the evaluation of internal movement of funds and “interest” dealings between different parts of the same enterprise.

126. There is a wide range of possible functions carried out by the treasury of a bank and by parts of the enterprise that raise funds for use of another part of the same enterprise. These range, at one extreme, from complex functions organised on profit centre lines akin to full function banking to, at the other extreme, agent or conduit functions. Analysis of the treasury functions raises a number of areas for consideration, in particular, whether the dealings between a PE and treasury are priced at arm's length and whether they are undertaken in a similar manner to those of independent entities acting in their own interest. Often, the bank will have its own internal funds transfer pricing system, which governs the basis on which funds are transferred between different business units and treasury. It will be particularly important that such an internal mechanism allocates/divides interest margins between various business units and treasury within the bank in accordance with the arm's length principle. This section is intended to provide general guidance on how to do this.

127. It will be essential to carry out, under the first step of the WH, a full functional and factual analysis. This should concentrate on identifying the exact functions performed (especially the risks assumed) in relation to any treasury or interest dealing, and which part of the enterprise performs them.

128. Internal funds transfer pricing systems operated by treasury can be used to transfer interest rate risk and liquidity risk from branches/business units to treasury to facilitate efficient management of such risks (see section D-2(iii)(b)) and to allocate the costs of funds raised by the bank as a whole to individual branches (see paragraphs 91-94). Such systems may differentiate between product lines or market segments (e.g. setting different target profits and compensations), can facilitate the setting of target earnings for the entity, and serve as a basis for determining customer prices. Accordingly, internal funds transfer prices which are also used for tax purposes should be closely analysed to ensure their consistency with the arm's length principle.

129. The second step of the WH will apply the transfer pricing methods in the Guidelines to make a comparison between the dealings and uncontrolled transactions so as to ensure the dealings are at arm's length prices and so can be used to attribute an arm's length profit to the PE. When making this analysis, the comparison should be based on the dealing as structured by the taxpayer, e.g. in terms of amount, currency, duration, other terms and conditions and any associated hedging transactions, except in the 2 circumstances outlined in paragraph 1.37 of the Guidelines. The five comparability factors discussed in section D-2 (ii) above will need to be borne in mind, for example any differences in market conditions due to regulation.

130. Given the wide range of treasury operations, it is likely that a variety of methods will need to be employed. CUPs may be available, especially for the more routine operations. At the other extreme, where there is considerable integration of treasury functions, it may be that it is not possible to apply reliably traditional transaction methods. Transactional profit methods will need to be applied. It might also be that the treasury function is organised in such a way as to approximate to a CCA between associated enterprises, such that the guidance in Chapter VIII of the Guidelines needs to be followed.

131. There are also four other matters that flow from a treasury dealing that need to be considered. The first is that a treasury dealing will normally lead to the creation of a financial asset once the funds

raised are lent to a customer of the bank. In such cases an amount of the “free” capital of the bank will need to be attributed to that asset. This will have the consequence of increasing the gross margin on the treasury dealing because not all of the funds will have been borrowed (see Section D-1 (iii)).

132. The second relates to the conclusion already discussed that each part of the banking enterprise shares in the credit rating of the bank as a whole and the implications of this conclusion for carrying out a comparability analysis. The third relates to the question whether there is any credit risk to take account of in respect of any internal “interest” dealing as there is no risk of default by one part of an enterprise in relation to any other part of the same legal entity

133. The fourth relates to losses, especially foreign exchange (FX) gains and losses on financial assets. Under the WH, the function that assumes the FX risks in respect of those assets would be attributed the expected profit for assuming the FX risks and so would also be attributed any losses arising from realisation of those risks.

134. Some Steering Group members have voiced concerns about manipulation of FX losses for tax avoidance purposes. It is suggested that such manipulation can equally apply between independent enterprises (often between a bank and an unrelated MNE). Therefore, it is considered that such matters should not be dealt with under transfer pricing or attribution of profit rules. However, the WH should not be interpreted as counteracting the effects of any remedial legislation introduced by a jurisdiction to deal with problems not confined to related parties.

135. The Steering group is continuing to explore the issues related to treasury dealings, including the relationship with Tier 2 Capital discussed at paragraphs 92-94 above.

iii) Sales/trading functions

136. Under the first step of the WH, the financial assets created by the performance of the sales/trading functions by the PE will have been attributed to the PE. The effect of this would be to attribute to the PE performing this function the interest income produced by those assets. The interest income will be at arm’s length prices, either by definition, because it is received from independent enterprises, or, by application of the usual transfer pricing rules, if received from associated enterprises. Consequently, there will be no need to attempt to measure the performance of this function itself. Instead, in order to attribute an arm’s length profit to the PE, all that is necessary would be to determine the arm’s length prices for any “dealings” resulting from the performance of the other functions as described above.

137. However, it may not always be possible to evaluate those other functions in isolation from the sales/trading functions, for example because independent parties always perform such functions together. In such cases, it may therefore not be possible to apply reliably a traditional transaction method. Fortunately, Chapter III of the Guidelines approves other methods to be applied in situations where the traditional transaction methods of Chapter II cannot be applied reliably. The use of the transactional profit split method has already been discussed in the more limited context of the global trading of financial instruments in the Global Trading Report, where many of the same features, such as integration of functions and co-operation between locations can be found, albeit perhaps in a more extreme form and much more frequently. The Steering Group is still exploring the issues surrounding the application of profit methods to evaluate traditional banking functions.

2) Split sales/trading functions

138. Where the functional analysis under the first step of the WH shows that sales/trading functions related to the creation of the asset are performed partly in one jurisdiction and partly in another, this raises the issue of which part of the enterprise should be considered the “owner” of the financial asset and so have attributed to it the benefits and risks of ownership of the asset, in the form of the associated interest income and expense. As noted at paragraph 51 above, this determination is to be based on the functional analysis.

139. In traditional banking activities, unlike in global trading, it would generally be possible from the functional analysis to determine that the significant sales/trading functions leading to the creation of the asset were performed in only one location and that the other locations performed less significant functions. In such cases, the location performing the significant sales/trading functions would have the asset attributed to it and so be treated as the “owner” of the financial asset and the associated interest income and expense. There would be dealings to take into account between the location treated as the “owner” of the asset and the locations performing the other functions. These would be rewarded in accordance with the arm’s length principle, for example by means of a sales commission or service fee.

140. Exceptionally, the functional analysis may show that the significant sales/trading functions have been performed in more than one location so that the asset can be considered as owned jointly. This joint ownership creates a “dealing” that has important consequences for the attribution of profit. This is because the attribution of the financial asset, and therefore the associated “free” capital, follows the sales/trading function. The relative value of the sales/trading function performed in the different parts of the enterprise will be used to attribute the financial asset and consequently the “free” capital necessary to support that asset. For example, if it were determined that 60% of the value of the sales/trading functions were performed in the PE and 40% in head office, the financial asset would similarly be attributed 60% to the PE and 40% to head office.

141. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative value of the sales/trading functions performed in the different parts of the enterprise. The performance of the sales/trading functions will be characterised as “dealings” between the different parts the enterprises and comparisons will be sought with transactions between independents. All the methods approved in the Guidelines are available to make this determination, starting with the traditional transaction methods described in Chapter II.

142. However, it may be difficult to find uncontrolled transactions comparable to the “dealings”. For example, it has sometimes been suggested that broking transactions between independents could be used as comparable transactions under the CUP method. The high degree of discretion or judgement involved in the performance of a full sales/trading function is likely to result in material differences from broking transactions. Following paragraph 2.7 of the Guidelines, the broking transactions would only be comparable if “reasonably accurate adjustments can be made to eliminate the material effects of such differences”. It may be difficult to make such adjustments in practice. Additionally, the “dealings” might be structured in a different way from that found between independents or a split sales/trading function might involve considerable integration and co-operation between the different locations involved. Such integration or co-operation may be rare between independents and the degree of integration and co-operation may make it difficult to evaluate any transaction in isolation so that it may be difficult to apply reliably any of the traditional transaction methods.

143. Such problems are not confined to bank PEs and occur with increasing frequency in transactions between associated enterprises. Again, Chapter III of the Guidelines approves other methods to be applied

in situations where the traditional transaction methods of Chapter II cannot be applied reliably, as already discussed in the section immediately above.

144. One method, which might be particularly applicable in these circumstances, is the residual profit split method. This would split the residual profit resulting from the performance of the sales/trading function, i.e. the profit remaining after deducting from the combined profit, the arm's length remuneration for the performance of the other functions (i.e. "the basic return" in the language of paragraph 3.19 of the Guidelines). The remuneration for the other functions will have been determined by the use of arm's length pricing methods as described in the Guidelines and discussed in section D-2(iii)(b). The residual would still need to be split between the sales/trading locations in accordance with the general guidance in Chapter III of the Guidelines. Some further practical guidance may be obtained from Sections III-3 and IV of the Global Trading Report.

b) Functions involved in managing an existing asset

145. The WH applies equally to the functions listed at paragraph 6 above that are necessary to monitor and manage the financial asset during its life. The attribution of profit to the loan support functions and to the sales/trading function should be made in the same way as already described for the performance of the similar function leading to the creation of a financial asset. This section looks in more detail at risk monitoring and risk management functions.

146. Risk monitoring has relevance to the broad range of risk types and includes all risk information systems and reporting. Internal control systems will monitor the utilisation of facilities against stipulated risk limits and report on excesses. For example, credit risk may be monitored in terms of the amount at risk and the quality of risk (the likelihood of default) and loan portfolio risk concentrations. Credit risk monitoring is critical as the default of a small number of significant customers could generate large losses for the bank. Where the risk monitoring function is relatively unsophisticated, it should be possible to use traditional transactional methods to attribute profit in respect of "dealings" related to this function. On the other hand, where the risk monitoring function is so integrated with other functions (e.g. the risk management function) that it is not practicable to evaluate it on a separate basis, the use of other methods may be necessary.

147. The management of risk within a traditional banking business (i.e. the borrowing and lending of money), has undergone considerable change since the 1984 Report was issued. Traditionally, this only involved the management of the credit risk associated with the banking book (traditional loan activities). More recently, the management of market risks (interest and currency risks) associated with loans made to customers has also become an important function undertaken within banks (often managed by treasury) and in more sophisticated banks, some market risks may be transferred to a trading book. It is recognised that there are differences in the risks, and in the way those risks are managed, between a traditional banking business and a global trading business. Nevertheless, it is considered that the guidance in the Global Trading Report on rewarding risk management functions may be helpful in the context of evaluating the performance of risk management functions in a traditional banking business. The Steering Group is exploring these issues in more detail.

148. The method of rewarding the performance of the risk management function will depend on the exact nature of the function performed and the risks managed. As noted in the Global Trading Report (see paragraphs 148-154 on trading and risk management), profit methods may have to be used where it is not possible to apply reliably traditional transaction methods to reward the performance of risk management functions. This may occur where independent enterprises performing similar risk management functions would demand a share of the profit or where the risk management function is so integrated with the other

functions that is not possible to make an evaluation in isolation. This can be either a share of the gross or the net profits.

149. Where the risk management function has to be rewarded by a profit method, the part of the enterprise performing that function will need to share in the profits of the assets that it is risk managing. In such cases, the part of the enterprise performing those functions will be treated as a joint owner of the assets it is risk managing not only for the purposes of sharing the profits from those assets but also for the purposes of capital attribution (see section D-1 (iii) above). For example, suppose a PE risk manages a portfolio of assets and is rewarded by receiving 50% of the profits from that portfolio. Under the WH, it would also be treated as having a 50% ownership of that asset portfolio for the purposes of attributing the capital of the bank as a whole to the PE.

c) Transfers of existing financial assets

150. The discussion in the report so far has considered the situation where the financial asset has remained in the location where it was created, based on where the sales/trading functions leading to its creation were carried out.

151. The question to be discussed in this section is what to do where that asset is subsequently transferred to another part of the enterprise. Under the WH, it must be decided whether such a transfer should be recognised at all. As discussed in Part I of this report, the WH relies on a functional analysis to determine whether there has been “a real and identifiable event” which would give rise to a dealing to be taken into account for the purpose of attributing profit. In the context of a financial asset, a book transfer of the financial asset must be accompanied by a real and identifiable event, such as a change in use of the financial asset. Transferring where an existing financial asset is booked, without transferring any of the functions and the assumption of the profit and risk potential of the financial asset, would not result in a change of use of that asset or any dealing in respect of that asset.

152. If the particular asset transfer is recognised as a dealing under the recognition test above, the next stage is to attribute profit in respect of that dealing. Generally, the transfer of the financial asset will be found under the comparability analysis to equate to a deemed disposal and acquisition at market value. The part of the enterprise acquiring the financial asset will have attributed to it from the date of acquisition the subsequent interest income and expenses associated with the ownership of the financial asset. The financial asset will also be attributed to the acquirer for the purposes of attributing the bank’s capital (see section D-1 (iii) above). The other functions necessary to maintain the financial asset will be rewarded as already discussed in the locations where they are now performed.

153. Some countries consider that the WH, as expressed above, does not provide sufficient protection against tax motivated transfers. However, it should be noted that the WH only determines the attribution of business profits in respect of a financial asset. The WH would not override any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of financial assets.

d) Head office services

154. A considerable head office support infrastructure is considered necessary in order to carry out a banking business. These cover a wide range of activities from strategic management to centralised payroll and accounting functions. The existence of these support functions needs to be considered when attributing profit to the various parts of the enterprise. The WH is to apply the guidance in the Guidelines, especially Chapters VII and VIII, to determine whether, and if so, to what extent, the support functions should be

rewarded. Part I of this Report discusses how this guidance can be applied, by analogy, to a PE and reflects the testing of the WH in the banking area.

155. One area where there is a difference between the WH and the existing position arises from the fact that under the WH, the arm's length principle is applied to determine the reward for performing that service. Application of that principle will take account not only of the price applied to the service but whether, at arm's length, both parties would have contracted for the provision of the service. As noted in Part I of this Report, the tests at paragraph 7.6 of the Guidelines will prove helpful in resolving such issues. Moreover, application of the arm's length principle may indicate a price for the service rendered that is above or below the costs incurred by the head office in providing it.

156. Most of the services provided by the head office of a bank are little different from those provided by the parent, or centralised service provider, of a MNE group. Similar techniques can be used as for associated enterprises and guidance on support services in the financial sector has been provided in Chapters III - 2 and III - 3 of the Global Trading Report. If CUPs are unavailable, cost plus methods may be particularly useful.

157. Where there is found to be a "CCA" type arrangement, the guidance in Chapter VIII on applying the arm's length principle to services that are the subject of the CCA activity should be followed. No particular issues are considered to arise in a banking business.

158. As noted in Part I of this Report, some Steering Group members have expressed reservations about the desirability of the outcome described above. **Views from the public are invited on this issue.**

(iv) Agency or conduit functions

159. This section deals with the situation described in the 1984 report (paragraphs 73-75) where, "one branch of a bank will use another branch simply as an instrument for raising funds on a foreign capital market for its own purposes It may in fact be doing little more than providing services as a conduit for the funds." It does not deal with internal "interest" dealings between a branch and treasury which are discussed in section D-2(iii)(a)(1)(ii). Further, it is assumed in this section that a PE has already been found to exist within the meaning of Article 5. The question of whether the performance of agency or conduit functions can, by themselves, lead to the creation of a PE under Article 5 is beyond the scope of this Report.

160. The significance of the branch having been found to act as an agent or conduit lies in the profit to be attributed in respect of such a function. This function would be, "remunerated not by interest but by an appropriate fee. This consideration could take the form of a "turn" - a small fraction of the funds raised or a small fraction of the profit made - if this is how independent enterprises would have arranged the transaction." Paragraph 74 of the 1984 Report discussed the evidence that might be required before the tax authority would accept the nature of the transaction as one of acting as agent or conduit. The main concern was to ensure that, "the domestic entity had not sacrificed to the other parts of the enterprise a profit which it could have made in the normal course by lending the money to an independent client itself."

161. The tax issues, and concerns of the tax authorities, have not changed significantly since the 1984 report. Moreover, the WH should provide a useful tool for making the determination as to whether a particular "dealing", the transfer of funds from one branch to another should be treated as comparable to a lending function, rather than to an agency or conduit function, with the resulting difference in attribution of profit. In particular, the concept of functional analysis, especially taking into account risks assumed, should enable this determination to be made on a principled and consistent basis.

162. The determination will be made by reference to the functions actually performed by the parties to the “dealing” and the circumstances surrounding the performance of those functions. For example, there can be no presumption in a “dealing” involving a PE and Head Office that the PE is acting as an agent or conduit for Head Office. Rather the guidance on functional analysis involved in creating a new financial asset (paragraph 5 above) should determine which functions necessary to create the asset have been carried out by which part of the enterprise. In particular, the detailed analysis of the sales/trading function will be vital, as this will determine which part of the enterprise has acted as the principal in respect of this transaction, e.g. which part of the enterprise made the decision to raise funds, the decision to enter the market at a particular time and the decision as to what terms should be sought etc.

163. As well as the making of the decision to raise funds, the other critical difference between “agency or conduit” functions and lending functions lies in the assumption of risk. If a bank borrows funds to onlend there are a number of risks it assumes. For example, the risk that it might not be able to find a customer for those funds (perhaps due to the rapid onset of recession), or on terms which would allow it to make a profit (perhaps due to unexpected market interest rate movements). It is the assumption of all the risks involved in borrowing or lending transactions which, in economic terms, justifies the full lending return. An agency or conduit function is characterised by the elimination of most, or all, of the risks relating to the performance of that function. In the example given in this paragraph, risk would be eliminated by the principal being obliged to take the funds at the rate raised by the agent or conduit (plus the remuneration for the services of the agent or conduit).

164. Following the guidance in Part I of this Report, all the facts and circumstances (including any relevant documentation) surrounding the purported agent or conduit dealing will have to be examined in order to, “deduce the economic relationships” between the parties and, in particular, the division of risks. Once the true terms of the dealing have been so determined, it can be seen whether those terms are indeed consistent with the performance of an agency or conduit function.

165. In conclusion, it is considered that the determination of the true nature of an “agency or conduit” dealing does not present any insurmountable problems, provided a full examination of all the relevant economic circumstances is made. The guidance in Chapter 1 of the Guidelines should be of considerable assistance in this matter.

166. Once the true nature of the dealing has been determined, the question remains of how to attribute profit to the participants to that dealing. Here the concept of comparability analysis will be important - the “dealing” will have profit attributed to it by reference to transactions between independents that are “comparable” within the meaning of Chapter I of the Guidelines. The most important comparability factors are likely to be the functional analysis (exact type of agency or conduit function and what, if any, risks are assumed (e.g. does the agent or conduit bear any risk, e.g. market risk, even for a short time)) and the characteristics of the transaction (see paragraph 1.19 of the Guidelines and paragraph 107 of this Report), especially the size of the funds raised and the currency involved.

167. However, the other factors mentioned in Chapter 1 should also not be overlooked, even if only to dismiss them as not relevant. For example, if the conduit dealing involves US dollars, the guidance on economic circumstances (see paragraph 1.30) is likely to be less important, as comparables are likely to be in a similar market and market conditions, given the deep, liquid and global nature of the financial market for US dollars. The position might be different for a dealing in an illiquid currency or one where a few participants dominate the market for raising funds in that currency.

168. The availability of comparable data is likely to determine the method chosen for attributing profit. Agency or conduit transactions occur between independents in financial markets and so market data should often be available. Such market data are likely to be in the form of potential comparable

uncontrolled prices (CUPs), often expressed as a “turn” on the funds borrowed. The amount of the turn would be determined from market transactions that meet the comparability standard of Chapters 1 and 2 of the Guidelines (see above for factors to be taken into account).

169. In other cases CUPs may be found in the form of fees or commissions, although such data can be often, for the purposes of comparison, converted into an interest rate “turn”. Comparable data should not be ignored simply because it is expressed in a different form. However, where it is not possible to locate comparable uncontrolled transactions, the other methods approved in the Guidelines will need to be applied in order to resolve the issue.